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# Tax Information on Partnerships

For use in preparing  
**1994** Returns

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## Important Changes for 1994

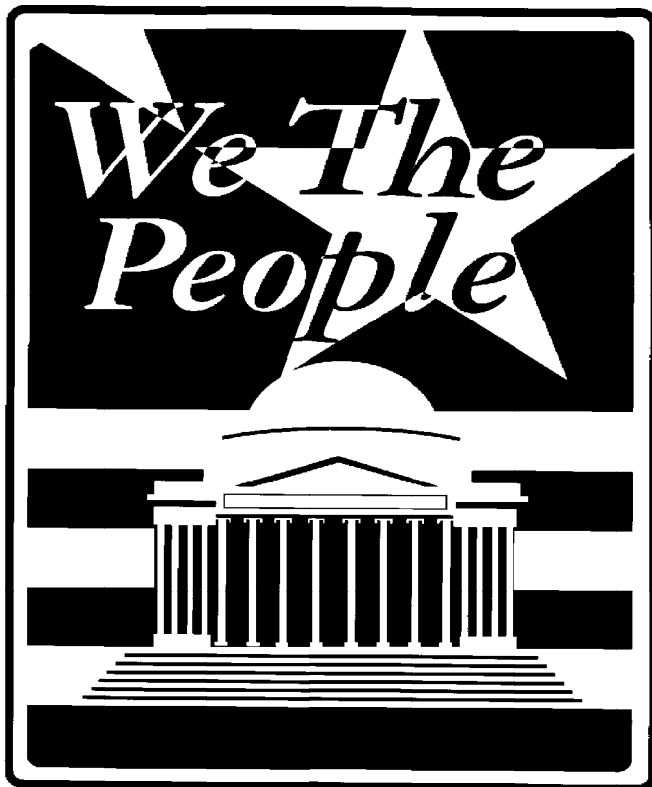
**Health insurance deduction for the self-employed.** The 25% deduction for health insurance costs for self-employed persons expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend the provision. See Publication 553, *Highlights of 1994 Tax Changes*, for information.

**Rental real estate activity.** For tax years beginning after 1993, passive activities do not include a rental real estate activity in which the partner materially participates. The partner must meet other conditions. See *Passive activities*, later.

**Estimated tax for individuals modified.** Generally, the required payment for estimated tax for individuals is the smaller of:

- 1) 90% of the total expected tax for the current year, or
- 2) 100% of the total tax shown on the prior year's tax return.

However, for tax years beginning after 1993, individuals with adjusted gross income of more than \$150,000 (\$75,000 if married and filing a separate return) must substitute 110% in (2) above. This rule does not apply to individuals who receive at least two-thirds of their gross income from farming or fishing. See Publication 505 for more information.



**Capital gains exclusion for small business stock.** Beginning in 1998, a partner may be able to exclude up to 50% of the gain from the sale or exchange of qualified small business stock that was:

- 1) Originally issued after August 10, 1993.
- 2) Held by the partnership for more than 5 years.

See Internal Revenue Code section 1202 for the definition of qualified small business stock and special rules that apply to partners.

## Important Reminders

**Definition of “substantially appreciated” inventory modified.** The definition of substantially appreciated inventory has been modified. If the partnership’s inventory is worth more than 120% of its adjusted basis, the inventory is treated as substantially appreciated. The modified definition of substantially appreciated inventory applies to sales, exchanges, and distributions after April 30, 1993. See *Inventory items that have appreciated substantially in value*, later.

**Treatment of certain payments to retired or deceased partners.** New rules apply to the liquidation of a partner’s interest for partners retiring or dying on or after January 5, 1993. They do not apply to any partner retiring on or after that date if a written contract to purchase the partner’s interest in the partnership was binding on January 4, 1993, and at all times thereafter. See *Payments in liquidation of retiring or deceased partner’s interest*, later.

**Discharge of qualified real property business indebtedness.** Partners may elect to exclude from gross income certain income from discharge of qualified real property business indebtedness in tax years ending after 1992. See *Discharge of qualified real property business indebtedness*, later.

**Net capital gains treated as investment income.** For tax years beginning after 1992, net capital gain from the disposition of property held for investment may be excluded from investment income for purposes of computing the investment interest limitation. For more information, see Publication 550, *Investment Income and Expenses*.

**Increased expensing deduction.** The amount allowed to be expensed under section 179 of the Code is increased from \$10,000 to \$17,500 for property placed in service in tax years beginning after 1992. For more information, see Publication 534.

**Jobs credit extended.** The targeted jobs credit has been extended for employees who begin work for the employer after June 30, 1992, and before January 1, 1995. For an employee who began work after August 9, 1993, the jobs credit is not allowed for any employee who is related to a partner who owns more

than 50% of the capital and profits interest of the partnership.

**Meal and entertainment expenses.** For tax years beginning after 1993, the deductible part of otherwise allowable business meals and entertainment expenses is reduced from 80% to 50%.

## Introduction

This publication explains how the tax law applies to partnerships and to partners. A partnership does not pay tax on its income but “passes through” any profits or losses to its partners. Partners must include partnership items on their tax returns.

For a discussion of business expenses a partnership can deduct, see Publication 535. Members of oil and gas partnerships should read the discussion of depletion in Chapter 13 of that publication to figure their deductions for depletion.

Certain partnerships must have a tax matters partner who is also a general partner. For information on the rules for designating a tax matters partner (TMP), see the instructions for Form 1065 and section 301.6231(a)(7)–1T of the Income Tax Regulations.

### Useful Items

You may want to see:

#### Publication

- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **533** Self-Employment Tax
- ☐ **534** Depreciation
- ☐ **535** Business Expenses
- ☐ **537** Installment Sales
- ☐ **538** Accounting Periods and Methods
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **551** Basis of Assets
- ☐ **556** Examination of Returns, Appeal Rights, and Claims for Refund
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **946** How To Begin Depreciating Your Property

#### Form (and Instructions)

- ☐ **1065** U.S. Partnership Return of Income
- ☐ **Schedule K–1 (Form 1065)** Partner’s Share of Income, Credits, Deductions, Etc.
- ☐ **1128** Application to Adopt, Change, or Retain a Tax Year
- ☐ **3115** Application for Change in Accounting Method
- ☐ **4562** Depreciation and Amortization
- ☐ **8308** Report of a Sale or Exchange of Certain Partnership Interests
- ☐ **8582** Passive Activity Loss Limitations

- ☐ **8736** Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts

**Ordering publications and forms.** To order free publications and forms, call our toll-free telephone number 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

**Telephone help.** You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call toll free 1–800–829–1040.

**Telephone help for hearing-impaired persons.** If you have access to TDD equipment, you can call 1–800–829–4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

## General Information

This section discusses general topics such as the definition of a partnership, which partnerships can be excluded from partnership treatment, partnership agreements, termination of a partnership, filing requirements, and family partnerships.

### Partnership Defined

A partnership is the relationship between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill, and each expects to share in the profits and losses. “Person,” when used to describe a partner, means an individual, a corporation, a trust, an estate, or another partnership.

For federal income tax purposes, the term “partnership” includes a syndicate, group, pool, joint venture, or similar organization that is carrying on a trade or business and is not classified as a trust, estate, or corporation.

A joint undertaking merely to share expenses is **not** a partnership. Mere co-ownership of property maintained and leased or rented is **not** a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

**Limited liability company (LLC).** An LLC is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified as a partnership or corporation for federal income tax purposes, depending on whether it has more than two of the following corporate characteristics:

- 1) Centralization of management.
- 2) Continuity of life.
- 3) Free transferability of interests.
- 4) Limited liability.

## Exclusion from Partnership Treatment

Certain partnerships can choose to be completely or partially excluded from being treated as a partnership for federal income tax purposes if all the partners agree. However, partners of a partnership electing to be partially excluded from partnership treatment are not exempt from the provisions that limit a partner's distributive share of partnership loss. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year, discussed later.

**Eligible partnerships.** This exclusion applies only to certain unincorporated investing or operating partnerships where there is no active conduct of a business.

**Investing partnership.** An investing partnership can be excluded if the participants in the joint purchase, retention, sale, or exchange of investment property:

- 1) Own the property as co-owners.
- 2) Reserve the right separately to take or dispose of their shares of any property acquired or retained.
- 3) Do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange the investment property. Each separate participant can delegate authority to purchase, sell, or exchange his or her share of the investment property for the time being for his or her account, but not for a period of more than a year.

**Operating agreement partnership.** An operating agreement partnership group can be excluded if the participants in the joint production, extraction, or use of property:

- 1) Own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights.
- 2) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used.
- 3) Do not jointly sell services or the property produced or extracted. Each separate participant can delegate authority to sell his or her share of the property produced or extracted for the time being for his or her account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year. However, this does not apply to an unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

**Election for exclusion.** If you are a participant in an eligible unincorporated organization described above and wish to be excluded completely or partially from the partnership provisions of the Code, see section 1.761-2 of the Income Tax Regulations for the procedures to request this exclusion.

**Time for making the election.** Any unincorporated organization that wishes to be excluded from the partnership rules of the Code must make the election not later than the time for filing the partnership return for the first tax year for which exclusion is desired.

However, an organization may be deemed to have made the election in a proper manner if it can be shown by all the facts and circumstances that it was the intention of the members of the organization at the time of its formation to secure exclusion from the partnership rules of the Code, beginning with the first tax year of the organization.

## Partnership Agreement

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be oral or written.

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extensions of time.

A partner's share of income, gains, losses, deductions, or credits is usually determined by the partnership agreement.

However, the partnership agreement or any modification will be disregarded if the allocations to a partner under the agreement do not have substantial economic effect, defined under *Distributive Share*, later. If the allocation does not have substantial economic effect, or the partnership agreement does not provide for the allocation, then the partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

## Termination of a Partnership

A partnership terminates when:

- 1) All of its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership, or
- 2) At least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

See Regulations section 1.708-(1)(b) for more information on the termination of a partnership.

**Date of termination.** The partnership's tax year ends on the date of termination. For purposes of (1) above, the date of termination is the date the partnership completes the winding up of its affairs. For purposes of (2) above, the date of termination is the date the partnership interest is sold or exchanged which, of itself or together with other sales or exchanges

in the preceding 12 months, transfers an interest of 50% or more in both partnership capital and profits.

**Short period return.** If a partnership is terminated before the end of the tax year, Form 1065 must be filed for a period of less than 12 months (short period). The return is due the 15th day of the fourth month following the date of termination. See *Filing Requirements*, next, for information about filing Form 1065.

**Special rules.** See Regulations section 1.708-1(b)(2) for information on the special rules that apply to a merger, consolidation, or division of a partnership.

## Filing Requirements

Each partnership must file a return showing its income, deductions, and other required information (Form 1065). In addition, the partnership return shows the names and addresses of each partner and each partner's distributive share of taxable income. This is an information return and must be signed by a general partner. If a limited liability company, discussed earlier, is treated as a partnership and files Form 1065, one of the company members must sign the return.

A return must be filed for each tax year of the partnership, even if it has no income for the year. However, the first return is not required to be filed until the first tax year the partnership has income or deductions. See the instructions for Form 1065 for more information.

## Form 1065 Due Date

Form 1065 generally must be filed on or before April 15 following the close of the partnership's tax year if its accounting period is the calendar year. A fiscal year partnership generally must file its return by the 15th day of the 4th month following the close of its fiscal year.

If a partnership needs more time to file its return, it should file Form 8736 by the regular due date of its Form 1065. The automatic extension is 3 months.

If a partnership has made a section 444 election to use a tax year other than a required tax year, discussed later, the filing of an application for extension does not extend the time for making any required payment. Nor does an extension of time for filing a partnership return extend the time for filing a partner's personal income tax return.

If the date for filing a return or making a tax payment falls on a Saturday, Sunday, or legal holiday, the partnership can file the return or make payment on the next day that is not a Saturday, Sunday, or legal holiday.

**Schedule K-1 due to partners.** The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners on or before the date Form 1065 is required to be filed, including extensions.

## Penalties

To help ensure that returns are filed correctly and on time, the law provides penalties for failure to do so.

**Failure to file.** A penalty is assessed against any partnership that must file a partnership return and fails to file on time, including extensions, or fails to file a return with all the information required. The penalty is \$50 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month) the return is late or incomplete, up to 5 months.

The penalty will not be imposed if the partnership can show reasonable cause for its failure to file a complete or timely return. Certain small partnerships (with 10 or fewer partners) meet this reasonable cause test if all of the following apply:

- 1) Each partner is a natural person (other than a nonresident alien) or an estate,
- 2) Each partner's share of each partnership item is the same as his or her share of every other item, and
- 3) All partners have fully reported their shares of partnership income, deductions, and credits on their timely filed individual income tax returns.

The failure to file penalty is assessed against the partnership. However, each partner is individually liable for the penalty to the extent that the partner is liable for partnership debts in general.

If the partnership wants to contest the penalty, it must pay the penalty and sue for refund in a U.S. District Court or the U.S. Court of Federal Claims.

#### **Failure to furnish copies to the partners.**

The partnership must furnish copies of Schedule K-1 to the partners. A penalty for each statement not furnished will be assessed against the partnership unless the failure to do so is due to reasonable cause and not willful neglect.

**Trust fund recovery penalty.** If a person is responsible for withholding, accounting for, or depositing or paying withholding taxes and willfully fails to do so, he or she can be held liable for a penalty equal to the tax not paid, plus interest. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty. The person responsible for the collection and payment of withholding taxes can be subject to this penalty even if he or she is an officer or employee of a corporation or a member or employee of a partnership.

"Willfully" in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully.

**Other penalties.** Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement.

Other penalties include those for:

- 1) Not supplying a taxpayer identification number.
- 2) Not furnishing information returns.

- 3) Overstating tax deposit claims.
- 4) Underpaying tax due to a valuation overstatement.
- 5) Not furnishing information on tax shelters.
- 6) Promoting abusive tax shelters.

However, some penalties may not be imposed if there is reasonable cause for noncompliance.

## **Family Partnerships**

Members of a family can be partners. Members of a family include only spouses, ancestors, and lineal descendants (or any trust for the primary benefit of those persons).

**Family members as partners.** Family members will be recognized as partners only if one of the following requirements is met.

- 1) If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest, or
- 2) If capital is not a material income-producing factor, they must have joined together in good faith to conduct a business. In addition, they must have agreed that contributions of each entitle them to a share in the profits. Some capital or service must be provided by each partner.

**Capital is material.** Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plants, machinery, or equipment.

**Capital is not material.** In general, capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

**Capital interest.** A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest if:

- 1) He or she withdraws from the partnership, or
- 2) The partnership liquidates.

The mere right to share in earnings and profits is not a capital interest in the partnership.

**Gift.** If a family member receives a gift of a capital interest in a family partnership in which capital is a material income-producing factor, there are limits on the amount that can be allocated to that member (donee) as a distributive share of partnership income. To determine the limits for a donee's share:

- 1) The partnership income must be reduced by reasonable compensation for services rendered to the partnership by the donor, and

- 2) The donee-partner's share of the remaining profits allocated to donated capital must not be proportionately greater than the donor's share attributable to the donor's capital.

**Purchase.** An interest purchased by one member of the family from another member is considered a gift.

**Example.** A father sold 50% of his business to his son. The resulting partnership had a profit of \$60,000. Capital is a material income-producing factor. The father performed services worth \$24,000, which is reasonable compensation, and the son performed no services. The \$24,000 must be allocated to the father as compensation. Of the remaining \$36,000 of income due to capital, at least 50%, or \$18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership income cannot be more than \$18,000.

## **Husband-Wife Partnerships**

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065. They should **not** report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor.

Each spouse should carry his or her share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Schedule SE (Form 1040), *Self-Employment Tax*. Usually this will not increase their total tax but it will give each spouse credit for social security earnings on which retirement benefits are based.

## **User Fees**

The IRS charges fees for requests to issue certain tax rulings, determinations, and opinions, including:

- 1) Applications for changes in accounting periods (Forms 1128 and 2553).
- 2) Applications for changes in accounting methods (Form 3115).
- 3) Requests for extensions of time to make the election or application for relief in (1) and (2) above under section 301.9100 of the Income Tax Regulations.
- 4) Requests for most other rulings (including those for applications for changes in accounting periods, accounting methods, and earnings and profits, other than those applications submitted on Forms 1128, 2553, 3115, and 5452).

For a complete list of fees, see Publication 1380, *User Fees*.

## **Withholding**

If a partnership acquires a U.S. real property interest from a foreign person or firm, the partnership may have to withhold tax on the

amount it pays for the property (including cash, fair market value of other property, and any assumed liability). If a partnership has income that is effectively connected with a trade or business in the United States, it may have to withhold on the income allocable to its foreign partners. A partnership that fails to withhold may be held liable for the tax, applicable penalties, and interest. For more information, see Publication 515, *Withholding of Tax on Non-resident Aliens and Foreign Corporations*.

## Tax Year

A partnership determines its tax year as if it were a taxpayer. However, there are limits on the year it can choose. In general, a partnership must use its required tax year. Exceptions to this rule are discussed under *Exceptions to Required Tax Year*, later.

A partnership's tax year usually continues after the death of a partner, the entry of a new partner, or the liquidation, sale, or exchange of a partner's interest.

**Partners.** Partners may change their tax year only if they receive permission from the IRS. This also applies to corporate partners who are usually allowed to change their accounting periods without prior approval if they meet certain conditions.

## Required Tax Year

A partnership generally must conform its tax year to its partners' tax years as follows:

- 1) **Majority interest tax year.** If one or more partners having the same tax year own an interest in partnership profits and capital of more than 50% (a majority interest), the partnership must use the tax year of those partners.  
**Testing day.** The partnership determines if there is a majority interest tax year on the testing day, which is usually the first day of the partnership's current tax year. If a partnership's majority interest tax year changes, it will not be required to change to another tax year for 2 years following the year of change.
- 2) **Principal partner.** If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- 3) **Least aggregate deferral of income.** If there is no majority interest tax year or the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

**Least aggregate deferral of income.** The least aggregate deferral of income is determined by comparing the deferrals that all partners would get if the partnership used the tax year of each one of its partners. A computation

must be made for each partner whose tax year is different from the other partners as follows:

- 1) Determine the number of months of deferral for each partner using one partner's tax year. Find the months of deferral by counting the months from the end of the one partner's tax year forward to the end of each other partner's tax year.
- 2) Multiply each other partner's deferral period found in step (1) by that partner's share of interest in the partnership profits for the year used in step (1).
- 3) Add the amounts in step (2) to get the aggregate (total) deferral for that partner's tax year.
- 4) Repeat steps (1) through (3) for each partner's tax year that is different from the other partners' years.

The partner's tax year that results in the lowest aggregate (total) number is the tax year that must be used by the partnership. If more than one year qualifies as the tax year that has the "least aggregate deferral of income," the partnership may choose any year that qualifies. However, if one of the tax years that qualifies is already the partnership's existing year, the partnership must retain that year.

**52-53 week tax year.** If a partner or partnership uses a 52-53 week tax year, the partnership must use the tax year of the partner or the partnership that has been determined to have the least aggregate deferral of income.

**Special de minimis rule.** If the tax year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current tax year, the partnership's current tax year shall be treated as the tax year with the least aggregate deferral.

**Example.** Rose and Irene have equal shares in a partnership that uses a fiscal year ending June 30. Rose uses a calendar year while Irene has a fiscal year ending November 30. The partnership must change its tax year to a fiscal year ending November 30 because this results in the least aggregate deferral of income to the partners. This was determined as shown in the following table.

Year End 12/31	Year End	Profits Interest	Months of Deferral	Interest × Deferral
Rose	12/31	0.5	0	0
Irene	11/30	0.5	11	5.5
Total Deferral				5.5

Year End 11/30	Year End	Profits Interest	Months of Deferral	Interest × Deferral
Rose	12/31	0.5	1	0.5
Irene	11/30	0.5	0	0
Total Deferral				0.5

**Procedures.** Generally, this determination is made at the beginning of the partnership's current tax year. However, the IRS can require the partnership to use another day or period

that will more accurately reflect the ownership of the partnership.

Any required change under these rules will be treated as initiated by the partnership with the consent of the IRS. No formal application for a change in tax year is needed.

**Notifying IRS.** Any partnership that adopts, retains, or changes its tax year as required must notify the IRS by writing at the top of the first page of its tax return for its first required tax year, "FILED UNDER SECTION 806 OF THE TAX REFORM ACT OF 1986." The return must be filed by the due date (including extensions) of the first tax year affected. This will be either the return for the retained year or for the short period (for an adoption or change).

If a partnership is required to keep a calendar year, it does not need to notify the IRS.

**Short period return.** When a partnership changes its tax year, a short period return must be filed. The short period return covers the number of months between the end of the partnership's prior tax year and the beginning of its newly elected tax year. A statement must be attached to this short period return showing the computations that resulted in the tax year chosen. The short period return must indicate at the top of page 1 of Form 1065, "FILED UNDER SECTION 1.706-1T."

## Exceptions to Required Tax Year

There are exceptions to the required tax year rule. One exception allows a partnership that establishes a business purpose for a different tax year to use its natural business year. Another exception allows the partnership to make a section 444 election.

### Business Purpose Tax Year

If a partnership establishes an acceptable business purpose for having a tax year that is different from its required tax year, the different tax year can be used. The deferral of income to the partners is not considered a business purpose. See *Business Purpose Tax Year* in Publication 538 for more information.

### Section 444 Election

Partnerships can elect under section 444 to use a tax year that is different from the required tax year. Certain restrictions apply to this election. In addition, the electing partnership may be required to make a payment for the deferral. See *Required payment for partnerships*, later. This election does not apply to any partnership that establishes a business purpose for a different period.

A partnership can make a section 444 election if:

- 1) It is not a member of a tiered structure (see section 1.444-2T of the Income Tax Regulations),
- 2) It has not previously had a section 444 election in effect, and
- 3) It elects a year that meets the deferral period requirement.

**Deferral period.** Generally, a partnership can make a section 444 election only if the tax year it wants to use results in a deferral period of 3 months or less.

However, an election to change a tax year from its required year will be allowed only if the deferral period of the tax year it wants to use is not longer than the shorter of:

- 1) Three months or less, or
- 2) The deferral period of the tax year being changed.

For a partnership that wants to **adopt or change** its tax year by making a section 444 election, the deferral period is the number of months between the end of the tax year it wants to use and the close of the required tax year. If the current tax year is the required tax year, the deferral period is zero.

**Example 1.** BD Partnership uses a calendar tax year which is also its required tax year. Because BD's deferral period is zero, BD is not able to make a section 444 election.

**Example 2.** E, a newly formed partnership, began operations on December 1, 1994. E is owned by calendar year partners. E wants to make a section 444 election to adopt a September 30 tax year. E's deferral period for the tax year beginning December 1, 1994, is 3 months (the number of months between September 30 and December 31, 1995).

**Making the election.** You make a section 444 election by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year*, with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

- 1) The due date (without regard to extensions) of the income tax return resulting from the section 444 election, or
- 2) The 15th day of the sixth month of the tax year for which the election will be effective. For this purpose, count the month in which the tax year begins even if it began after the first day of that month.

In addition, you must attach a copy of Form 8716 to your Form 1065 for the first tax year for which the election is made.

**Example 1.** AB, a partnership, began operations on September 9, 1994, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 9, 1994. AB must file Form 8716 by January 17, 1995, which is the due date of the partnership's tax return for the period September 9, 1994, to September 30, 1994.

**Example 2.** The facts are the same as in Example (1) except that AB began operations on October 21, 1994. AB must file Form 8716 by March 15, 1995, the 15th day of the sixth month of the tax year for which the election will first be effective.

**Extension of time for filing.** You may qualify for an automatic extension of 12 months to make this election. See Revenue Procedure 92-85 for more information.

**Effect of election.** Partnerships that make a section 444 election must make certain required payments. These payments are discussed later.

**Ending the election.** The section 444 election remains in effect until it is terminated. The election ends when the partnership:

- 1) Changes to its required tax year,
- 2) Liquidates,
- 3) Willfully fails to comply with the required payments, or
- 4) Becomes a member of a tiered structure.

If the election is terminated, another section 444 election cannot be made for any tax year.

**Required payment for partnerships.** Partnerships must make a "required payment" for any tax year that the section 444 election is in effect and the required payment amount is more than \$500. You also must pay if you had a required payment for any prior tax year that was more than \$500 and you have a liability of any amount for that applicable year.

Any tax year that a section 444 election is in effect, including the first year, is called an "applicable election year." This required payment represents the value of the tax deferral that the owners receive through the use of a tax year different from the required tax year.

Report the required payment on Form 8752, *Required Payment or Refund Under Section 7519*. If the required payment is more than \$500 (or the required payment for any prior year was more than \$500), pay it when Form 8752 is filed. If the required payment is \$500 or less, and no payment was required in a prior year, no payment is required, but Form 8752 must be filed showing a zero amount.

**When to file.** Form 8752 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins. For example, if a partnership's applicable election year begins July 1, 1994, Form 8752 must be filed by May 15, 1995.

**Back-up election.** If you have requested, or plan to request, permission to use a tax year that has a business purpose, you can file a section 444 election (if you otherwise qualify) as a backup to your requested business year. If you are denied your request for a business purpose tax year, you must then activate your back-up section 444 election.

**Making back-up election.** Follow the general rules for making a section 444 election, as discussed earlier. In addition, type or print "BACK-UP ELECTION" at the top of Form 8716. However, if you file Form 8716 on or after the date you file Form 1128, *Application to Adopt, Change or Retain a Tax Year*, for your requested business purpose year, type or print at the top of Form 8716 "FORM 1128 BACK-UP ELECTION."

**Activating election.** Partnerships activate their back-up election by filing the return required and making the required payment with Form 8752 and printing at the top of the form,

"ACTIVATING BACK-UP ELECTION." The due date for filing Form 8752 and the payment is the later of:

- 1) May 15 of the calendar year following the calendar year in which the applicable election year begins, or
- 2) 60 days after the partnership has been notified by the IRS that the business year request has been denied.

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## Income, Deductions, and Allocations

A partnership is **not** a taxable entity. However, a partnership must figure its total income and file Form 1065, which provides information on partnership income or losses for the year.

### Partnership Income

A partnership computes its income and files its return in the same manner as an individual. However, a partnership must state certain items of gain, loss, income, etc., separately and certain deductions are not allowed to the partnership.

The partnership, not the partners, makes most choices about how to compute income. These include choices for:

- 1) Accounting methods.
- 2) Depreciation methods.
- 3) Accounting for specific items, such as depletion or installment sales.
- 4) Nonrecognition of gain on involuntary conversions of property.
- 5) Amortization of certain organization fees and business startup costs of the partnership.

However, each partner, not the partnership, decides how to treat foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of indebtedness.

For more information on the following topics, see the listed publication.

- 1) Accounting methods: Publication 538.
- 2) Depreciation: Publication 534.
- 3) Installment sales: Publication 537.
- 4) Amortization and depletion: Chapters 12 and 13 in Publication 535.
- 5) Involuntary conversions: Chapter 26 in Publication 334, *Tax Guide for Small Business*.

**Organization expenses and syndication fees.** Neither the partnership nor any partner can deduct, as a current expense, amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

The partnership can choose to amortize certain organization expenses over a period of not less than 60 months. The period must start

with the month the partnership begins business. This election is irrevocable and the period the partnership chooses in this election may not be changed. If the partnership elects to amortize these expenses and is liquidated before the end of the amortization period, the remaining balance in this account may be deductible as a loss.

**Amortizable expenses.** Amortization applies to expenses that:

- 1) Are incident to the creation of the partnership.
- 2) Are chargeable to a capital account.
- 3) Are the type that would be amortized if they were incurred in the creation of a partnership having a fixed life.

An expense that fails to meet one or more of these three tests does not qualify as an organization expense for the purpose of amortizing such expenses. To qualify, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date for filing the partnership return (not including extensions) for the tax year in which the partnership begins business.

In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. The expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership.

For example, organization expenses that can be amortized include:

- 1) Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement.
- 2) Accounting fees for services incident to the organization of the partnership.
- 3) Filing fees.

**When to deduct.** If a partnership uses the cash method of accounting, no deduction is allowed for a tax year for any expenses that are not paid by the end of that tax year. Any amortization for organization expenses that may have been allowed in a prior tax year, if the expenses had been paid, are deductible in the year paid.

**Making the election.** Make the election to amortize organization expenses by attaching a statement to the partnership's return for the tax year the partnership begins its business. The statement must provide:

- 1) A description of each organizational expense (whether paid or not).
- 2) The amount of each expense.
- 3) The date each expense was incurred.
- 4) The month the partnership began its business.
- 5) The number of months (not less than 60) over which the expenses are to be amortized.

A cash basis taxpayer must also indicate the amount paid before the end of the year for each expense. Expenses that are less than \$10 need not be separately listed, provided the total amount of these expenses is listed with the dates on which the first and last of these expenses were incurred.

**Expenses not amortizable.** Organization expenses that cannot be amortized (regardless of how the partnership characterizes them) include expenses connected with:

- 1) Acquiring assets for the partnership or transferring assets to the partnership.
- 2) The admission or removal of partners other than at the time the partnership is first organized.
- 3) A contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members).
- 4) Syndication of the partnership. Expenses such as commissions, professional fees, and printing costs connected with the issuing and marketing of interests in the partnership are capitalized. Syndication fees can never be deducted by the partnership, even if the syndication is unsuccessful.

## Partner's Income

A partner's taxable income for a tax year includes his or her distributive share of certain partnership items for the partnership's tax year ending with or within the partner's tax year. A partner must report his or her distributive share of partnership items on his or her tax return whether or not it is actually distributed. These items are reported to the partner on Schedule K-1 (Form 1065). See the instructions for Form 1065 for more information.

To determine the allowable amount of any deduction or exclusion subject to a limit, a partner must combine any separate deductions or exclusions on his or her income tax return with the distributive share of partnership deductions or exclusions before applying the limit.

**Estimated tax.** Partners may have to make payments of estimated tax as a result of partnership distributions.

Generally, the required payment for estimated tax for individuals is the smaller of:

- 1) 90% of the total expected tax for the current year, or
- 2) 100% of the total tax shown on the prior year's tax return.

However, for tax years beginning after 1993, individuals with adjusted gross income of more than \$150,000 (\$75,000 if married and filing a separate return) must substitute 110% in (2) above. This rule does not apply to individuals who receive at least two-thirds of their gross income from farming or fishing.

See Publication 505 for more information.

**Partnership expenses paid by a partner.** In general, a partner cannot deduct partnership

expenses paid out of personal funds unless required to do so by the partnership agreement. These expenses are usually considered incurred and deductible by the partnership.

If an employee of the partnership performs part of a partner's duties and the partnership agreement requires the partner to pay the employee out of personal funds, the partner can deduct the payment as a business expense.

**Treatment of partnership items.** Partners must treat partnership items the same way on their individual tax returns as they are treated on the partnership return. If a partner treats an item differently on his or her individual return, the IRS can automatically assess and collect any tax and penalties that result from adjusting the item to make it consistent with the partnership return. However, this rule will not apply if a partner identifies the different treatment by filing Form 8082, *Notice of Inconsistent Treatment or Amended Return*, with his or her return.

**Examination procedures.** Under current examination procedures, the tax treatment of any partnership item is determined at the partnership level in a unified partnership proceeding, rather than at the individual partner's level. After the proper treatment is determined at the partnership level, the IRS can automatically make related adjustments to the tax returns of the partners, based on their share of the adjusted items.

These examination procedures do not apply to small partnerships that have 10 or fewer partners who are individuals (other than non-resident alien individuals) or estates. This rule applies if each partner's share of every partnership item is the same as that partner's share of every other item. However, small partnerships can make an election to have these procedures apply.

For more information on these procedures, see Publication 556.

## Distributive Share

A partner's distributive share of certain items of income, gain, loss, deduction, or credit must be reported on his or her tax return, even though the partnership does not actually distribute any money to the partner. However, a partner's distributive share of a loss may be limited. See *Losses*, later.

Generally, the partnership agreement determines a partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit. A partner can find his or her distributive share on Schedule K-1 (Form 1065). Do **not** include with Form 1065 or its Schedule K-1 any personal income tax return you file.

**Distributive share determined by interest in partnership.** A partner's distributive share of each item is determined by his or her interest in the partnership (taking into account all facts and circumstances) if either of the following applies:

- 1) The partnership agreement does not provide for the allocation of income, gain,

loss, deduction, or credit (or item thereof), or

- 2) The allocation of income, gain, loss, deduction, or credit (or item thereof) to any partner under the agreement does not have substantial economic effect.

The allocation is done by taking into account the partner's contributions to the partnership, the interests of all partners in profits and losses (if different from interests in taxable income or loss), cash flow, and the rights of the partners to distributions of capital upon liquidation.

**Substantial economic effect.** An allocation has substantial economic effect if both of the following apply:

- 1) There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners' shares of partnership income or loss independently of tax consequences, and
- 2) The partner to whom an allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

**Nonrecourse liability.** A nonrecourse liability is one for which no partner or related person has any personal liability. An allocation of a loss, deduction, or partnership expense attributable to nonrecourse liabilities that is not deductible or chargeable to capital cannot have economic effect. A partner's share of nonrecourse deductions is determined by his or her interest in the partnership. For the rules on determining nonrecourse deductions, see section 1.704-2 of the Income Tax Regulations.

**Character of items.** The character of certain items of income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if the partner:

- 1) Realized the item directly from the same source as the partnership, or
- 2) Incurred the item in the same manner as the partnership.

For example, a partner's distributive share of gain from the sale of partnership depreciable property used in the trade or business of the partnership is treated as gain from the sale of depreciable property that the partner used in a trade or business.

**Self-employment tax.** A partner's distributive share of income from a partnership is usually included in figuring net earnings from self-employment. If an individual partner has net earnings from self-employment of \$400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040). For more information on self-employment tax, see Publication 533.

**Tax preference income.** To figure alternative minimum tax, a partner must separately take into account any distributive share of items of income and deductions that enter into the

computation of alternative minimum taxable income. For information on which items of income and deductions are affected, see the Form 6251 instructions.

**Gross income.** When it is necessary to determine the gross income of a partner, the partner's gross income includes his or her distributive share of the partnership's gross income. For example, each partner's share of the partnership gross income is used in determining whether an income tax return must be filed by that partner.

**Distribution of borrowed funds.** If the partnership distributes borrowed funds to a partner, the partnership should list the interest expense of these funds as "Interest expense allocated to debt-financed distributions" under other deductions on the partner's Schedule K-1. The partner deducts this interest on his or her tax return depending on how the partner uses the funds. See Chapter 8 in Publication 535 for more information on the allocation of interest expense related to debt-financed distributions.

**Gain or loss on distributions.** Generally, the way a partner treats distributions or withdrawals from a partnership depends on the reason for the distribution or withdrawal.

A distribution of money that is a return of part of a partner's adjusted basis in the partnership is not included in that partner's income unless it exceeds his or her adjusted basis. If partnership property is distributed to a partner, he or she does not recognize any gain until the sale or disposition of the property.

A partner does not recognize a loss unless his or her entire interest in the partnership is liquidated, and only if the distribution is in money, unrealized receivables, or inventory items. If the partner receives any other type of property, no loss is recognized. See *Unrealized Receivables and Inventory Items*, later.

**Caution.** At the time this publication went to print, Congress was considering legislation that would include marketable securities in the term "money." For more information, see Publication 553, *Highlights of 1994 Tax Changes*.

**Example.** The adjusted basis of Jo's partnership interest is \$10,000. She receives a distribution of \$8,000 cash and land that has a fair market value of \$3,000. Her basis for the land is \$2,000, but she realizes no immediate gain. Any gain on the land she receives is recognized when she sells or otherwise disposes of the property.

**Certain distributions of property.** If a partnership makes a distribution to a partner after June 24, 1992, the partner generally will have a gain equal to the lesser of:

- 1) The excess of:
  - a) The fair market value of any property (other than money) received, over
  - b) The adjusted basis of the partner's interest in the partnership immediately before the distribution reduced (but not

below zero) by any money received in the distribution, or

- 2) The net precontribution gain of the partner.

The character of the gain is determined by reference to the proportionate character of the net precontribution gain. This gain is in addition to any gain the partner must recognize if the amount of money distributed is more than his or her basis in the partnership.

**Net precontribution gain.** This is the net gain that the distributee partner would have recognized if all the partnership property that had been contributed by that partner within 5 years of the distribution, and held by the partnership immediately before the distribution, had been distributed by the partnership to another partner.

**Effect on basis.** The adjusted basis of the partner's interest in the partnership is increased by any gain recognized by this partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution. See *Basis of Partner's Interest*, later.

The partnership must adjust its basis in any property that the partner contributed within 5 years of the distribution to reflect any gain that partner recognizes under this rule.

**Exception 1.** If any of the distributed property is property that the partner had contributed to the partnership, the property is not taken into account in determining either:

- 1) The excess of the fair market value of any property received over the adjusted basis of the partner's interest in the partnership, or
- 2) The partner's net precontribution gain.

If any interest in an entity is distributed, this exception does not apply to the extent that the value of the interest is due to property contributed to the entity after the interest in the entity had been contributed to the partnership.

**Exception 2.** This rule does not apply to a distribution of either:

- 1) Unrealized receivables or substantially appreciated inventory items of the partnership, discussed later, in exchange for all or part of a partner's interest in other partnership property, or
- 2) Other partnership property in exchange for all or part of a partner's interest in unrealized receivables or substantially appreciated inventory items of the partnership.

#### **Property distributed to another partner.**

In addition, for property contributed to a partnership after October 3, 1989, the contributing partner must recognize gain or loss on a distribution of the property to another partner within 5 years of the contribution. The gain or loss is equal to the amount the contributing partner would have recognized if the property had been sold for its fair market value when it was distributed. The character of the gain or loss will be the same as the character that would have resulted if the partnership had sold the



property to the distributee partner. Appropriate adjustments must be made to the adjusted basis of the contributing partner's partnership interest and to the adjusted basis of the property distributed to reflect any gain or loss recognized.

**Losses.** A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's partnership interest. The adjusted basis is figured at the end of the partnership's tax year in which the loss occurred, before taking the loss into account. Any loss that is more than the partner's adjusted basis is not deductible for that year. However, any loss not allowed for this reason will be allowed as a deduction (up to the partner's basis) at the end of any succeeding year in which the partner increases his or her basis to more than zero. See *Basis of Partner's Interest*, later.

**Example.** Mike and Joe are equal partners in a partnership. Mike files his individual return on a calendar year basis. The partnership return is also filed on a calendar year basis. The partnership incurred a \$10,000 loss last year and Mike's distributive share of the loss is \$5,000. The adjusted basis of his partnership interest before considering his share of last year's loss was \$2,000. He could claim only \$2,000 of the loss on last year's individual return. The adjusted basis of his interest at the end of last year was then reduced to zero.

The partnership showed an \$8,000 profit for this year. Mike's \$4,000 share of the profit increased the adjusted basis of his interest by \$4,000 (not taking into account the \$3,000 excess loss he could not deduct last year). His return for this year will show his \$4,000 distributive share of this year's profits and the \$3,000 loss not allowable last year. The adjusted basis of his partnership interest at the end of this year is \$1,000.

**Activities not engaged in for profit.** Deductions relating to activities not engaged in for profit are limited. For a discussion of these limitations, see Chapter 1 in Publication 535.

**At-risk limits.** At-risk rules apply to most trade or business activities, including activities conducted through a partnership or for the production of income. The at-risk rules limit the loss a partner can deduct on amounts for which that partner is considered at risk in the activity.

A partner is considered at risk for:

- 1) The amount of money and the adjusted basis of any property he or she contributed to the activity,
- 2) The income retained by the partnership, and
- 3) Certain amounts borrowed by the partnership for use in the activity.

However, a partner is generally not considered at risk for amounts borrowed unless that partner is personally liable for repayment, or the amounts borrowed are secured by the partner's property (other than property used in the activity).

A partner is not considered at risk for amounts protected against loss through guarantees, stop-loss agreements, or similar arrangements. Nor is the partner at risk for amounts borrowed if the lender has an interest in the activity (other than as a creditor), or if the lender is related to a person (other than the partner) having such an interest.

For more information on determining the amount at risk, see Publication 925.

**Passive activities.** Generally, Code section 469 limits the amount you can deduct for passive activity losses and credits. The passive activity limits do not apply to the partnership. Instead, they apply to each partner's share of loss or credit from passive activities. Because the treatment of each partner's share of partnership income, loss, or credit depends on the nature of the activity that generated it, the partnership must report income, loss, or credits separately for each activity.

Generally, passive activities include activities that involve the conduct of a trade or business if the partner does not materially participate in the activity. The level of each partner's participation must be determined by the partner.

**Rental activities.** Passive activities also include rental activities, regardless of the partner's participation. However, for tax years beginning after 1993, passive activities do not include a rental real estate activity in which the partner materially participates. The partner must also meet both of the following conditions for the tax year:

- 1) More than half of the personal services a partner performs in any trade or business are in a real property trade or business in which the partner materially participates.
- 2) The partner performs more than 750 hours of service in a real property trade or business in which the partner materially participates.

**Limited partners.** Limited partners are generally not considered to materially participate in trade or business activities conducted through partnerships.

**More information.** For more information on passive activities, see Publication 925 and the instructions to Forms 1065 and 8582.

**Section 179 deduction.** You can elect to deduct the cost of certain assets under section 179 of the Code.

**Limits.** The section 179 deduction is subject to certain limits that apply to both the partnership and to each partner. The partnership determines its section 179 deduction subject to the limits. It then allocates the deduction among its partners.

Each partner adds the amount allocated from the partnership (shown on Schedule K-1) to his or her other nonpartnership section 179 costs and then applies the maximum dollar limit to this total to determine the section 179 deduction. To determine if a partner has exceeded the \$200,000 investment limit, the business cost of section 179 property placed in service by the partnership is not attributed to

any partner. The total amount of each partner's section 179 deduction for partnership and nonpartnership property is subject to both the taxable income limit and the maximum dollar limit.

**Figuring taxable income for a partnership.** Taxable income (or loss) from the active conduct by a partnership of any trade or business is figured by adding together the net income (or loss) from all trades or businesses actively conducted during the tax year. To determine the total amount of partnership items, deductions and losses are treated as negative income.

**Partner's share of partnership taxable income.** For purposes of section 179, a partner who is engaged in the active conduct of one or more of a partnership's trades or businesses includes his or her allocable share of taxable income derived from the partnership's active conduct of any trade or business.

**Different tax years.** For purposes of section 179, if the tax year of a partner and the partnership differ, the amount of a partnership's taxable income attributable to a partner for a tax year is generally the partner's distributive share for the partnership tax year that ends with or within the partner's tax year.

**Example.** John and James Oak are equal partners in Oak Company. The company uses a tax year ending January 31. John and James both use a tax year ending December 31. For tax year ending January 31, 1994, Oak Company has taxable income from the active conduct of its trade or business of \$80,000, of which \$70,000 was earned during 1993. John and James each include \$40,000 of partnership taxable income in computing their taxable income limit.

**Basis adjustment.** A partner who is allocated section 179 expenses from the partnership must reduce the basis of his or her partnership interest by the total section 179 expenses allocated, regardless of whether the full amount allocated can be currently deducted. If a partner disposes of his or her interest in a partnership, the partner's basis for determining gain or loss is increased by any outstanding carryover of disallowed deduction of section 179 expenses allocated from the partnership.

The basis of a partnership's section 179 property must be reduced by the section 179 deduction elected by the partnership. This reduction of basis must be made even if a partner cannot deduct all or part of the partner's allocated section 179 deduction because of the limits.

**More information.** See Publication 534, *Depreciation*, for more information on the section 179 deduction.

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## Partner's Dealings With Partnership

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. These transactions include:

- 1) Performing services for or transferring property to a partnership if—
  - a) There is a related allocation and distribution to a partner, and
  - b) The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.
- 2) Transferring money or other property to a partnership if—
  - a) There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and
  - b) The transfers together are properly characterized as a sale or exchange of property.

**Sales and exchanges.** Special rules apply to sales or exchanges of property between partnerships and certain persons.

**Losses.** Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% interest of the capital or profits in each partnership, no deduction of a loss is allowed.

In either case, if the purchaser later sells the property, any gain realized will be taxable only to the extent that it is more than the loss that was not allowed.

**Gains.** Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following apply:

- 1) More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s), and
- 2) The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes trade accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

**Determining ownership.** To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply.

- 1) An interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) An individual is considered to own the interest that is directly or indirectly owned by or for the individual's family. For this rule, "family" includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.

- 3) If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest, thus making another person the constructive owner.

**Example.** Individuals A and B and Trust T are equal partners in Partnership ABT. A's husband, AH, is the sole beneficiary of Trust T. Trust T's partnership interest will be attributed to AH only for the purpose of further attributing the interest to A. This attribution makes A a more-than-50% partner. This means that any deduction for losses on transactions between her and ABT will not be allowed, and any gains will be treated as ordinary rather than capital gains.

**Payments by accrual basis partnership to cash basis partner.** A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amounts are paid. The partner must include these payments in income. However, this does not apply to guaranteed payments made to a partner, which are generally deductible when accrued.

**Guaranteed payments.** A partnership treats guaranteed payments to a partner for services, or for the use of capital, as if they were made to a person who is not a partner. This is true only to the extent the payments are figured without regard to the partnership's income. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to tax withholding.

The payments are generally deductible by the partnership as a business expense. They are included in Schedules K and K-1 of the partnership return and are reported by the individual partner on Form 1040 as ordinary income, in addition to the appropriate distributive share of the other ordinary income from the partnership.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenditures and are not deductible by the partnership. However, these payments must be included in the partners' individual income tax returns. See *Organization expenses and syndication fees*, earlier.

**Including payments in income.** A partner includes the guaranteed payments in income in the partner's tax year in which the partnership's tax year ends.

**Example 1.** Under the terms of a partnership agreement, Erica is entitled to a fixed annual payment of \$10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. The partnership has \$50,000 of ordinary income

after deducting the guaranteed payment. She must include ordinary income of \$15,000 on her individual income tax return for her tax year in which the partnership's tax year ends (\$10,000 guaranteed payment plus \$5,000 (\$50,000 × 10%) distributive share).

**Example 2.** Chuck is a calendar year taxpayer who is a partner in a partnership. The partnership is on a fiscal year that ends January 31, 1995. He received guaranteed payments from the partnership from February 1, 1994, until December 31, 1994. He must include these guaranteed payments in his income for 1995 and report them on his 1995 income tax return.

**Minimum payment.** If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income **before** taking into account the guaranteed payment.

**Example.** Under a partnership agreement, Chris is to receive 30% of the partnership income, but not less than \$8,000. The partnership has net income of \$20,000. Chris's share, without regard to the minimum guarantee, is \$6,000 (30% of \$20,000). Thus, the amount of the guaranteed payment that may be deducted by the partnership is \$2,000 (\$8,000 less \$6,000). Chris's income from the partnership is \$8,000, and the remaining \$12,000 will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been \$30,000, there would have been no guaranteed payment since his share, without regard to the guarantee, would have been greater than the guarantee.

**Payments resulting in loss.** If a partnership agreement provides for guaranteed payments to a partner and the payments result in a partnership loss in which the partner shares, the partner must:

- 1) Report the full amount of the guaranteed payments as ordinary income, and
- 2) Separately take into account the appropriate distributive share of the partnership loss.

#### **Gain or loss on discharge of indebtedness.**

If a partnership acquires indebtedness of a partner (either corporate or noncorporate), and the partnership distributes the indebtedness to the partner so that the debt is extinguished, the partnership distribution of property rules apply in their usual fashion to determine the consequences for the partnership. For the partnership, the distribution of the debt will not result in gain or loss.

Because there will be no opportunity for recognition at a future time, the partner will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness.

In addition, receipt of the indebtedness by a partner may require the partner to include in

gross income discharge of indebtedness income. The partner is treated as having satisfied the debt for its fair market value. The amount of discharge of indebtedness income is equal to the amount by which the issue price (adjusted for any premium or discount) of the indebtedness exceeds the fair market value of the indebtedness.

Similarly, a deduction may be available to the partner if the fair market value of the indebtedness at the time of distribution exceeds its adjusted issue price.

**Discharge of qualified real property business indebtedness.** A partner can elect to exclude from gross income certain income from discharge of qualified real property business indebtedness. The amount excluded cannot exceed the partner's basis in certain depreciable real property and is treated as a reduction in the basis of that property.

Qualified real property business indebtedness is indebtedness (other than qualified farm debt):

- 1) That was incurred or assumed in connection with real property used in a trade or business,
- 2) That was secured by such real property,
- 3) That was incurred or assumed:
  - a) Before January 1, 1993, or
  - b) If incurred or assumed on or after that date, is to acquire, construct, or substantially improve such real property, and
- 4) To which a partner elects to apply these rules.

Qualified indebtedness includes refinancing of indebtedness described in (3) above, but only to the extent it does not exceed the amount of indebtedness being refinanced.

The amount excluded may not exceed:

- 1) The excess (if any) of:
  - a) The outstanding principal amount of the debt (immediately before the discharge), minus
  - b) The fair market value (immediately before the discharge) of the business real property that is security for the debt, reduced by any outstanding principal amount of any other qualified real property business indebtedness secured by this property as of the time of the discharge.
- 2) The partner's share of the total adjusted bases of depreciable real property (after reductions of tax attributes) held by the partnership immediately before the discharge. Depreciable real property acquired in contemplation of the discharge is not taken into account.

**Determination made at partnership level.** The determination of whether debt is qualified real property indebtedness is made at the partnership level. For example, if a partnership debt is discharged, the determination of whether the debt was incurred or assumed in connection with real property used in a trade

or business is made by reference to the trade or business of the partnership and real property owned by the partnership.

However, the election to exclude income from discharge of indebtedness is made at the partner level on a partner-by-partner basis, to the extent of the partner's proportionate interest in the depreciable real property held by the partnership.

**Deemed distribution.** The deemed distribution arising from the reduction in a partner's share of partnership liabilities due to the discharge of partnership debt is treated as follows:

- 1) The allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by that amount.
- 2) The reduction in a partner's share of partnership liabilities caused by the debt discharge also results in a deemed distribution, which in turn results in a reduction of the partner's basis in his partnership interest. This basis reduction is separate from any other reduction in basis of the partner's interest.

**Basis of depreciable real property reduced.** If the basis of depreciable real property is reduced, and it is disposed of, then for purposes of determining the amount of recapture under section 1250:

- 1) Any such basis reduction is treated as a deduction allowed for depreciation, and
- 2) The determination of what would have been the depreciation adjustment under the straight line method is made as if there has been no such reduction.

Therefore, the amount of the basis reduction recaptured as ordinary income is reduced over the time the partnership continues to hold the property, as the partnership forgoes depreciation deductions due to the basis reduction.

**Capital or profits interest for services provided to the partnership.** A **capital interest** is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. The receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation.

A **profits interest** is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is not a taxable event for the partner or the partnership. However, this does not apply if:

- 1) The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease,

- 2) Within 2 years of receipt, the partner disposes of the profits interest, or
- 3) The profits interest is a limited partnership interest in a publicly traded partnership.

## Contributed Property

Usually, neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

The contribution of limited partnership interests in one partnership for limited partnership interests in another partnership may qualify as a tax-free contribution of property to the second partnership if the transaction is made for business purposes. Exchanges of partnership interests generally do not qualify for non-taxable treatment as exchanges of like-kind property.

A transaction may be treated as an exchange of property on which gain or loss is recognized if a partner contributes property to a partnership and within a short period:

- 1) Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership, or
- 2) After the contribution, the contributed property is distributed to another partner.

**Special rule for investment companies.** Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. A loss realized on a contribution of stock, securities, or other property to a partnership is not recognized.

A partnership is treated as an investment company if over 80% of the value of its assets, excluding cash and nonconvertible debt obligations, is held for investment and consists of readily marketable stocks, securities, or interests in regulated investment companies or real estate investment trusts. Whether a partnership is an investment company under this test is ordinarily determined immediately after the transfer of property.

These rules apply to both limited partnerships and general partnerships, regardless of whether they are privately formed or publicly syndicated.

**Interest acquired as compensation.** A partner can acquire an interest in partnership capital as compensation for services performed or to be performed. The fair market value of such an interest must generally be included in the partner's gross income in the first tax year in which the partner's interest can be transferred or is not subject to a substantial risk of forfeiture. Such a transfer of partnership interest as compensation for services is subject to the rules discussed in Chapter 2 of Publication 535 under *Payment in Restricted Property*.

The fair market value of an interest in partnership capital transferred to a partner as payment for services to the partnership is a guaranteed payment, discussed earlier.

**Partnership's gain or loss on contributed property.** For unrealized receivables, inventory items, and certain capital loss property contributed by a partner to a partnership, the character of the partnership's gain or loss on a later disposition is determined by the following rules.

- 1) **Unrealized receivables.** For property that was an unrealized receivable in the hands of the contributing partner, any gain or loss on a disposition by the partnership is ordinary income or loss. Unrealized receivables are defined later under *Unrealized Receivables and Inventory Items*. When reading the definition, substitute "partner" for "partnership."
- 2) **Inventory items.** For property that was an inventory item in the hands of the contributing partner, a gain or loss on a disposition by the partnership within 5 years after the contribution is ordinary income or loss. Inventory items are defined later in *Unrealized Receivables and Inventory Items*.
- 3) **Capital loss property.** For property that was a capital asset in the contributing partner's hands, any loss on a disposition by the partnership within 5 years, beginning with the contribution date, is a capital loss. The capital loss is limited to the amount the partner's adjusted basis of the property exceeds the property's fair market value immediately before the contribution.

**Nontaxable exchanges.** If any of the above property is disposed of by the partnership in a nontaxable exchange, these rules apply to a later disposition of any substituted basis property received by the partnership in the exchange. These rules also apply to a later disposition of any substituted basis property by the person or entity that received the property in the exchange.

**Basis of contributed property.** If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, and gain or loss for the property is the same as the partner's adjusted basis of the property when it was contributed, increased by any gain recognized by the partner at that time.

The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for all or any part of the difference.

However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership. The allocation can apply to all property contributed or only to specific

items. This rule also applies to accounts payable and other accrued but unpaid items of a cash basis partner.

**Example.** Sara and Gail form an equal partnership. Sara contributed \$10,000 in cash to a partnership and Gail contributed depreciable property with a fair market value of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Gail's hands, \$4,000.

In effect, Sara purchased an undivided one-half interest in the depreciable property with her contribution of \$10,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS), she would have been entitled to a depreciation deduction of \$500 per year, based on her interest in the partnership.

However, since the partnership is allowed only \$400 per year of depreciation (10% of \$4,000), no more than \$400 can be allocated between the partners.

## Basis of Partner's Interest

A partner's basis is determined by the following rules.

### General Basis Rules

The general rules cover the partner's original basis, adjusted basis, and share of partnership liabilities.

#### Original Basis

The original basis of a partnership interest acquired by a contribution of property, including money, is the money a partner contributed plus the adjusted basis of any property he or she contributed. If the property contribution results in taxable income to the partner, this income will generally be included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is also treated as a contribution of money to the partnership by the partner.

**Partner's liabilities assumed by partnership.** If the property contributed is subject to indebtedness or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as though they contributed money to the partnership.

**Example 1.** John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of \$8,000 and a \$4,000 mortgage. The partnership assumed payment of the mortgage. The adjusted basis of John's interest is:

Adjusted basis of contributed property .....	\$8,000
Minus: Part of mortgage assumed by other partners and treated as a distribution (80% of \$4,000) .....	3,200
<b>Basis of John's partnership interest .....</b>	<b>\$4,800</b>

**Example 2.** If, in the above example, the property John contributed had a \$12,000 mortgage, the adjusted basis of his partnership interest would be zero. The difference between the amount of the mortgage assumed by the other partners, \$9,600 (80% × \$12,000), and his basis of \$8,000 would be treated as his gain from the sale or exchange of a capital asset. However, this gain **would not** increase the basis of his partnership interest.

**Interest acquired by gift, etc.** If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Publication 551.

**Debt-financed acquisitions.** The interest expense on loan proceeds used to purchase an interest in, or make a contribution to, a partnership must be allocated as explained in Chapter 8 of Publication 535.

### Adjusted Basis

**Increases.** The basis of an interest is increased by the partner's:

- 1) Additional contributions to the partnership.
- 2) Distributive share of both taxable and nontaxable partnership income.
- 3) Distributive share of the excess of the deductions for depletion over the basis of the depletable property.

**Decreases.** The partner's basis is decreased (but never below zero) by:

- 1) The amount of money and the adjusted basis of property distributed to the partner by the partnership. (See *Partner's Basis of Property Received*, later.)
- 2) The partner's distributive share of the partnership losses (including capital losses).
- 3) The partner's distributive share of nondeductible partnership expenses that are not capital expenditures.
- 4) The amount of the partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
- 5) The partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.

**Book value of partner's interest.** The adjusted basis of a partner's interest is determined without considering any amount shown

in the partnership books as a capital, equity, or similar account.

**Example.** Sam contributes to the partnership property that has an adjusted basis of \$400 and a value of \$1,000. His partner contributes \$1,000 cash. While under the partnership agreement each has a capital account in the partnership of \$1,000, which will be reflected in the partnership books, the adjusted basis of Sam's interest is only \$400 and his partner's basis is \$1,000.

**Determination of adjusted basis.** The adjusted basis of a partner's partnership interest is ordinarily determined at the end of a partner's tax year. However, if there has been a sale or exchange of all or part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis is determined on the date of the sale, exchange, or liquidation.

## Partnership Liabilities

A partner's basis in a cash basis partnership includes a partnership liability only if, and to the extent that, the liability:

- 1) Creates or increases the partnership's basis in any of its assets,
- 2) Gives rise to a current deduction to the partnership, or
- 3) Decreases the partner's basis in the partnership.

The term "assets" includes capitalized items allocable to future periods, such as organization expenses. Partnership liabilities do not include accrued but unpaid expenses or accounts payable from a cash basis partnership.

**Increases.** If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

**Decreases.** If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

**Partner's share.** A partner's share of partnership liabilities depends on whether the liability is a recourse or nonrecourse liability.

**Recourse liability.** A partnership liability is a recourse liability to the extent that any partner or related person has an economic risk of loss for that liability. A partner's share of such liability equals that partner's share of the economic risk of loss.

**Nonrecourse liability.** A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability. A partner's share of such a liability generally is determined by the partner's ratio for sharing partnership profits.

**Limited partner.** A limited partner generally has no obligation to contribute additional capital to the partnership and therefore does not have an economic risk of loss in partnership liabilities.

**Assumption of liability.** A partner or related person is considered to assume a partnership liability only to the extent that:

- 1) He or she is personally liable for it, and
- 2) The creditor knows that the liability was assumed by the partner or a person related to the partner. The creditor must also be able to demand payment from the partner, and no other partner or person related to another partner may bear the economic risk of loss on that liability immediately after the assumption.

**Related persons.** Related persons, for these purposes, include:

- 1) An individual and his or her spouse, ancestors, and lineal descendants.
- 2) An individual and a corporation 80% or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.
- 3) Two corporations that are members of the same controlled group.
- 4) A grantor and a fiduciary of any trust.
- 5) Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
- 6) A fiduciary and a beneficiary of the same trust.
- 7) A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
- 8) A fiduciary of a trust and a corporation, 80% or more in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or a grantor of the trust.
- 9) A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by such person or by members of the family of such person.
- 10) A corporation and a partnership if the same person owns 80% or more in value of the outstanding stock of the corporation and 80% or more of the capital or profits interest in the partnership.
- 11) Two S corporations or an S corporation and a C corporation if the same persons own 80% or more in value of the outstanding stock of each corporation.
- 12) A partnership and a person owning, directly or indirectly, 80% or more of the capital or profit interest in the partnership, and
- 13) Two partnerships in which the same persons own, directly or indirectly, 80% or more of the capital or profits interests.

**Economic risk of loss.** A partner has an economic risk of loss if that partner or related person, defined earlier, is obligated (whether by

agreement or law) to make a net payment to the creditor or a contribution to the partnership with respect to the liability when the partnership is constructively liquidated. A partner that is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.

Generally, in a constructive liquidation, the following occurs:

- 1) All partnership liabilities become payable in full.
- 2) All of the partnership's assets have a value of zero, except for property contributed to secure a liability.
- 3) All property is disposed of by the partnership in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more assets of the partnership).
- 4) All items of income, gain, loss, or deduction are allocated to the partners.
- 5) The partnership liquidates.

**Example.** Ted and Jane form a general partnership with cash contributions of \$20,000 each. Under the partnership agreement, they share all partnership profits and losses equally. They borrow \$60,000 and purchase depreciable business equipment. This indebtedness qualifies as a partnership liability because incurring it creates an additional \$60,000 of basis in the partnership's depreciable property.

If neither partner has an economic risk of loss in the liability, it is a nonrecourse liability. Each partner's basis would include his or her share of the liability, \$30,000.

If Jane was required under the agreement to pay the creditor when the partnership defaulted, she would have an economic risk of loss in the liability. Her basis in the partnership would be \$80,000, while Ted's basis would be \$20,000.

**More information.** For more information on determining a partner's share of partnership liabilities, including rules for limited partners and examples, see sections 1.752-1 through 1.752-5 of the Income Tax Regulations.

## Alternative Basis Rule

In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated.

This alternative rule can be used to determine the adjusted basis of a partner's interest if either of the following applies:

- 1) The circumstances are such that the partner cannot practicably apply the general basis rules.
- 2) It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring a partner's adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

## Partner's Basis of Property Received

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

**Example 1.** The adjusted basis of Betty's partnership interest is \$30,000. She receives a distribution of property that has an adjusted basis of \$20,000 to the partnership and \$4,000 in cash. Her basis for the property is \$20,000.

**Example 2.** The adjusted basis of Mike's partnership interest is \$10,000. He receives a distribution of \$4,000 cash and property that has an adjusted basis to the partnership of \$8,000. His basis for the distributed property is limited to \$6,000 (\$10,000 minus \$4,000, the cash he receives).

**Holding period for distributed property.** A partner's holding period for property distributed to the partner by the partnership includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included. However, this does not apply for determining the 5-year period for substantially appreciated inventory items, explained later in *Sale or exchange of certain distributed property*.

**Complete liquidation of partner's interest.** The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

**Special rule.** In some instances, a special rule applies to transactions between partners and partnerships.

**Sale or exchange of interest in partnership.** To the extent that money or property received by a partner, in exchange for all or part of his or her partnership interest, is attributable to the partner's share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered an amount realized from the sale or exchange of property other than a capital asset.

**Certain distributions treated as a sale or exchange.** When a partnership distributes the following items, the distribution is treated as a

sale or exchange of property that is not a capital asset.

- 1) Unrealized receivables or substantially appreciated inventory items to a partner in exchange for any part of the partner's interest in other partnership property, including money, or
- 2) Other property (including money) in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

See *Unrealized Receivables and Inventory Items*, later, for definitions.

The partner's basis in the property actually received is its cost to the partner.

**Exceptions.** The special rule on certain distributions does not apply in the following situations:

- 1) A distribution of property to the partner who contributed the property to the partnership, and
- 2) Certain payments made to a retiring partner or successor in interest of a deceased partner.

**Basis divided among properties.** Generally, the basis of property received is limited to the adjusted basis of the partner's interest in the partnership, reduced by money received in the same transaction. This basis must be divided among any properties distributed to a partner. The basis must first be allocated to unrealized receivables and inventory items included in the distribution.

The receivables or inventory items generally cannot take a higher basis in the partner's hands than their common adjusted basis to the partnership immediately before the distribution. However, the items could have a higher basis if the distribution is treated as a sale or exchange under the *Special rule*, discussed earlier, or if the partner has a special basis adjustment for the property, discussed later under *Special adjustment to basis of property received*.

Any basis not allocated to unrealized receivables and inventory items must then be divided among any other properties distributed to the partner in the same transaction. The division must be in proportion to their adjusted bases in the hands of the partnership before the distribution.

**Example.** The adjusted basis of Ted's partnership interest is \$30,000. In complete liquidation of his interest, he receives \$10,000 in cash, his share of the inventory items having a basis to the partnership of \$12,000, and two parcels of land having adjusted bases to the partnership of \$12,000 and \$4,000.

The basis of Ted's partnership interest is reduced to \$20,000 by the \$10,000 cash. This \$20,000 basis is then divided among the properties he receives. The inventory items in his hands now have a basis of \$12,000. To divide the balance of \$8,000, he adds the bases of the land (\$12,000 + \$4,000) and takes  $[(12,000 \div 16,000) \times \$8,000]$  and  $[(4,000$

$\div 16,000) \times \$8,000]$ . The bases of the two parcels of land in his hands are \$6,000 and \$2,000, respectively.

**Partner's interest less than partnership basis.** If the partnership's adjusted basis for the unrealized receivables and inventory items distributed to a partner is more than the adjusted basis of the partner's interest, the amount of the partner's basis is allocated among these items in proportion to the partnership's adjusted bases of the items. The partner's basis must be reduced first by any money distributed in the same transaction.

**Example.** Jenny's basis for her partnership interest is \$18,000. In a distribution in liquidation of her entire interest, she receives \$12,000 cash, her share of inventory items having an adjusted basis to the partnership of \$12,000, and unrealized receivables having a basis to the partnership of \$8,000. The basis of her partnership interest is first reduced to \$6,000 by the \$12,000 cash she receives. This \$6,000 basis is then divided proportionately between the inventory items and the unrealized receivables. Her basis for the inventory items is \$3,600  $[(12,000 \div 20,000) \times \$6,000]$ . Her basis for the unrealized receivables is \$2,400  $[(8,000 \div 20,000) \times \$6,000]$ .

**Partner's interest more than partnership basis.** If the basis of a partner's interest to be divided is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

**Special adjustment to basis of property received.** If a partner receives a distribution of property other than cash, he or she may choose a special basis adjustment for the property. To do this, the distribution must be made within 2 years after the partner acquired any part of his or her partnership interest in a sale or exchange or upon the death of a partner. Also, the partnership must not have chosen the optional adjustment to basis, discussed later under *Optional Adjustment to Basis of Partnership Property*.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership chose the optional adjustment to basis. However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership previously chose the optional adjustment.

The special adjustment is only for the purpose of figuring the basis of the property to the partner receiving it.

A partner choosing this special basis adjustment must file with his or her tax return an attachment stating that the partner chooses under section 732(d) of the Internal Revenue Code to adjust the basis of property received in a distribution. The attachment must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated. The choice must be made with the

partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

**Example.** Bob purchased a 25% interest in X partnership for \$17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of \$14,000 and a fair market value of \$16,000. His purchase price reflected \$500 of this difference  $[(\$16,000 - \$14,000) \times \frac{1}{4}]$ . Thus, \$4,000 of the \$17,000 he paid was attributable to his share of inventory with a basis to the partnership of \$3,500.

Within 2 years after acquiring his interest, Bob withdrew from the partnership and for his entire interest received cash of \$1,500, inventory with a basis to the partnership of \$3,500, and other property with a basis of \$6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Since the partnership from which Bob withdrew did not make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His basis for the inventory is increased by \$500 ( $\frac{1}{4}$  of the \$2,000 difference between the \$16,000 fair market value of the property and its \$14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of his new basis in the property, and **not** for purposes of partnership gain or loss on disposition.

The total amount to be allocated among the properties Bob received in the distribution is \$15,500 (\$17,000 basis for his interest less \$1,500 cash received). His basis in the inventory items is \$4,000 (\$3,500 partnership basis plus \$500 special adjustment). The remaining \$11,500 is allocated to his new basis of the other property he received.

**Mandatory adjustment.** A partner does not always have a choice whether or not to use this special adjustment to basis. When property is distributed to a partner, the special adjustment to basis **must** be made if all of the following conditions existed when the partner received a partnership interest:

- 1) The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership.
- 2) If there had been a liquidation of the partner's interest immediately after the transfer, an allocation of the basis of that interest under the general rule (discussed earlier under *Basis divided among properties*) would have decreased the basis of property that could not be depreciated, depleted, or amortized, resulting in an increase in the basis of property that could be.
- 3) A special basis adjustment, if it had been chosen by the partnership, would have

changed the partner's basis of the property actually distributed.

## Optional Adjustment to Basis of Partnership Property

Generally, a partnership cannot adjust the basis of its property because of a distribution of property to a partner or because of a transfer of an interest in the partnership, whether by sale or exchange or because of the death of a partner. The partnership can adjust the basis only if it files an election to make an optional adjustment to the basis of its property upon the distribution or transfer. A partnership does not adjust the basis of partnership property for a contribution of property, including money, to the partnership.

**Distributions.** When there is a distribution of partnership property to a partner, the partnership makes the optional adjustment by:

- 1) Increasing the adjusted basis of the partnership property by —
  - a) The amount of any gain recognized by the distributee partner on the distribution, plus
  - b) The excess, if any, of the partnership's adjusted basis for the property (immediately before the distribution) over the basis of the property to the distributee, or
- 2) Decreasing the adjusted basis of the partnership property by —
  - a) The amount of any loss recognized by the distributee partner on the distribution, plus
  - b) The excess, if any, of the distributee partner's basis for the property over the partnership's adjusted basis for the property (immediately before the distribution).

**Transfers.** When there is a transfer of partnership interest because of a sale or exchange or a partner's death, the partnership makes the optional adjustment to the basis of its property by:

- 1) Increasing the adjusted basis of the partnership property by —
  - a) The excess of the transferee's basis for his or her partnership interest, over
  - b) The transferee's share of the adjusted basis to the partnership of all partnership property, or
- 2) Decreasing the adjusted basis of partnership property by —
  - a) The excess of the transferee partner's share of the adjusted basis of all partnership property, over
  - b) The transferee's basis for his or her partnership interest.

These adjustments affect the basis of partnership property for the incoming partner only. They become part of his or her share of the common partnership basis.

**Timing of adjustment.** If a partnership that has in effect an election to adjust basis completely liquidates the interest of a retiring partner by agreeing to make a series of cash payments that are treated as distributions, the basis adjustments to partnership property should correspond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

**Example.** Alan owns a one-third interest in partnership Sylvan Associates. Sylvan has an optional adjustment to basis election in effect. Sylvan continues without dissolution and agrees to liquidate Alan's one-third interest in the partnership property by making a series of cash payments to Alan that are treated as distributions. The total amount of payments Alan will receive is fixed and exceeds the adjusted basis of Alan's interest in the partnership.

The adjustment to the basis of partnership property should correspond in both timing and amount with the recognition of gain or loss by a retiring partner, or a deceased partner's successor in interest, with respect to payments that are treated as distributions.

Therefore, Sylvan must make basis adjustments, to the extent of Alan's recognized gain, in each partnership tax year during which Alan recognizes gain with respect to the payments that are treated as distributions.

**Making the election.** The optional adjustment to basis is made by filing a written statement with the partnership return, Form 1065, for the tax year in which the distribution or transfer occurs. For the election to be valid, the return must be filed on time, including extensions. The statement must include the name and address of the partnership, be signed by one of the partners, and state that the partnership elects under section 754 to apply sections 734(b) and 743(b) of the Internal Revenue Code. Once a valid election has been made, it applies in succeeding years until it is revoked.

If the election cannot be made on time, a partner or the partnership can request an automatic extension of 12 months to make the election. See Revenue Procedure 92-85 for more information.

**Revoking the election.** The election may be revoked only with the approval of the IRS. An application to revoke the election must be filed with the District Director for the district in which the partnership return must be filed. This application must be filed within 30 days after the close of the partnership tax year for which the change is to be effective. The application must be signed by one of the partners and state why the partnership wishes to revoke the election.

Examples of sufficient grounds for approving the application include:

- 1) A change in the nature of the business.
- 2) A substantial increase in assets.
- 3) A change in the character of the assets, or

- 4) An increased frequency of retirements or shifts of partnership interests.

However, no application for revoking the election will be approved if the purpose is primarily to avoid decreasing the basis of partnership assets upon a transfer or distribution.

## Sales, Exchanges, and Other Transfers

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, see *Ordinary gain or loss*, later, for certain exceptions. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of the liability relief as part of the amount realized for his or her interest.

**Example 1.** Fred became a limited partner in the ABC Partnership by contributing \$10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is \$20,000, which includes his share of partnership liabilities of \$15,000. The partnership has no other liabilities and no unrealized receivables or substantially appreciated inventory items. Fred sells his interest in the partnership for \$10,000 in cash. He had been paid his share of the partnership income for the tax year.

The amount realized by Fred from the sale of his partnership interest is \$25,000, consisting of the \$10,000 cash payment and his share of partnership liabilities of which he is relieved, \$15,000. Since the adjusted basis of his interest in the partnership is \$20,000, he realizes a gain of \$5,000, which he reports as a capital gain.

**Example 2.** The facts are the same as in Example 1, except that instead of selling his interest for \$10,000, Fred withdraws from the partnership when the adjusted basis of his interest in the partnership is zero. In this situation he is considered to have received a distribution of money from the partnership of \$15,000, the amount of liabilities of which he is relieved. Since the partnership has no unrealized receivables or substantially appreciated inventory items, he reports a capital gain of \$15,000.

**Ordinary gain or loss.** If the partnership had unrealized receivables or substantially appreciated inventory items, the amount realized that is attributable to these items is ordinary gain or loss. See *Unrealized Receivables and Inventory Items*, later.

**Abandoned or worthless partnership interest.** A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if:

- 1) The transaction is not a sale or exchange.

- 2) The partner has not received an actual or deemed distribution from the partnership.

If the partner receives even a de minimis actual or deemed distribution, the entire loss is a capital loss.

**Exchange of partnership interests.** Exchanges of partnership interests generally do not qualify as nontaxable exchanges of like-kind property. This applies regardless of whether they are general or limited partnership interests or interests in the same or different partnerships. However, under some circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership. See *Contributed Property*, earlier.

An interest in a partnership that has a valid election in effect under section 761(a) of the Internal Revenue Code to be excluded from all the partnership rules of the Code is treated as an interest in each of the partnership assets and not as a partnership interest.

**Installment reporting for sale of partnership interest.** A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. For requirements and other information on an installment sale, see Publication 537, *Installment Sales*.

The gain from the installment sale is treated in part as capital gain and in part as ordinary income if the partnership's assets included unrealized receivables and substantially appreciated inventory items. The term "unrealized receivables" includes depreciation recapture income discussed in Chapter 4 of Publication 544. An allocation must be made to ensure that the income is correctly reported.

The gain allocated to unrealized receivables and substantially appreciated inventory items is generally ordinary income and must be reported in the year of sale. The gain allocated to the other assets is capital gain and can be reported under the installment method.

## Liquidation of Partner's Interest

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated. The allocation is made between payments in liquidation and other payments.

For income tax purposes, a retiring partner or successor in interest to a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

**Payments in liquidation of retiring or deceased partner's interest.** Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership.

**Special rule.** Payments in exchange for an interest in partnership property do not include amounts paid for:

- 1) Unrealized receivables of the partnership, or
- 2) Goodwill of the partnership, except to the extent that the partnership agreement provides for a payment for goodwill.

This rule applies only if:

- 1) Capital is not a material income-producing factor for the partnership, and
- 2) The retiring or deceased partner was a general partner in the partnership.

Thus, if the retiring partner was not a general partner or if capital is a material income-producing factor, the partnership will not receive a deduction or its equivalent (distributive share) for the payments to the retired partner.

Capital is not a material income-producing factor if substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by a partner. The practice of his or her profession by a physician, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor, even though the practitioner may have a substantial capital investment in the professional equipment or physical plant of the practice, so long as the capital investment is merely incidental to the professional practice.

This rule applies to partners retiring or dying on or after January 5, 1993. It does not apply to any partner retiring on or after that date if a written contract to purchase the partner's interest in the partnership was binding on January 4, 1993, and at all times thereafter.

**Partners' valuation.** Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be adjusted so that both the value of and the basis for the partner's interest include the partner's share of partnership liabilities.

**Remaining partners' distributive shares.** The remaining partners' distributive shares are not reduced by payments in exchange for a retired partner's interest in partnership property.

**Gain on distribution.** Upon the receipt of the distribution, the partner will recognize a gain on the distribution only to the extent that any money distributed is more than the partner's adjusted basis in the partnership. The gain is a capital gain. However, any part of the gain that is for the partner's interest in substantially appreciated inventory items is treated as ordinary income. No gain is recognized on the distribution of property until the partner sells or otherwise disposes of it.

**Caution.** At the time this publication went to print, Congress was considering legislation that would include marketable securities in the term "money." For more information, see Publication 553, *Highlights of 1994 Tax Changes*.



**Loss on distribution.** The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received.

If inventory items are considered substantially appreciated, the loss on these items is an ordinary loss. Otherwise, the loss is a capital loss. The treatment of a distribution of unrealized receivables is discussed next under *Other payments*.

**Other payments.** Payments in liquidation of a general partnership interest in a partnership where capital is not a material income-producing factor are treated as distributive shares of partnership income or guaranteed payments if they are **not** made in exchange for an interest in partnership property. This rule applies regardless of the time over which the payments are to be made. It includes payments made for the partner's share of unrealized receivables and goodwill not treated as a distribution.

If the amount is based on partnership income, the payments are taxable as distributive shares of partnership income. These payments, reported by the recipient, retain the same character they would have had if they were reported by the partnership. If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

## Closing of Partnership Year

Generally, the partnership's tax year is not closed because of the sale, exchange, or liquidation of a partner's interest, the death of a partner, or the entry of a new partner. However, if a partner sells, exchanges, or liquidates his or her entire interest, the partnership's tax year is closed for that partner.

**Partner's taxable income.** If a partner disposes of his or her **entire interest** in a partnership, the partner must include his or her distributive share of partnership items in taxable income for the tax year in which membership in the partnership ends. To compute the distributive share of these items, the partnership's tax year is considered ended on the date the partner disposed of the interest. To avoid an interim closing of the partnership books, the partners can agree that the distributive share can be estimated by taking a prorated amount of the items the partner would have included in income if he or she had remained a partner for the entire partnership tax year.

A partner who sells or exchanges only **part of an interest** in a partnership, or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise), reports his or her distributive share of partnership items by taking into account his or her varying interests during the partnership year.

**Example.** ABC is a calendar year partnership with three partners, Alan, Bob, and Cathy. Under the partnership agreement, profits and losses are shared in proportion to each partner's contributions. As of January 1, this was 90% for Alan, 5% for Bob, and 5% for Cathy. On December 1, Bob and Cathy each contributed additional amounts so that the new profit and loss sharing ratios were 30% for Alan, 35% for Bob, and 35% for Cathy. For its tax year ended December 31, the partnership had a loss of \$1,200. This loss occurred equally over the partnership's tax year. The loss is divided among the partners as follows:

Partner	Profit or Loss % ×	Part of Year Held ×	Total Loss =	Share of Loss
Alan	90 ×	11/12 ×	\$1,200 =	\$ 990
	30 ×	1/12 ×	1,200 =	30
Bob	5 ×	11/12 ×	1,200 =	55
	35 ×	1/12 ×	1,200 =	35
Cathy	5 ×	11/12 ×	1,200 =	55
	35 ×	1/12 ×	1,200 =	35

**Proration of cash basis items.** If any partner's interest in a partnership changes during the tax year, each partner's share of certain cash basis items of the partnership must be determined by proring the items on a daily basis. That daily portion is then allocated to the partners in proportion to their interests in the partnership at the close of each day. This rule applies to the following items for which the partnership uses the cash method of accounting.

- 1) Interest.
- 2) Taxes.
- 3) Payments for services or for the use of property.
- 4) Any other item for which it is appropriate to use this rule to avoid significant misstatements of the partners' income.

**Deceased partner.** If a partner dies, the partner's estate or other successor in interest reports on its return the decedent's distributive share of the partnership items for the partnership year ending after the death occurred.

For example, if the partnership and the partners all use the calendar year as their tax year and one of the partners dies on June 10, none of the income of the partnership for that year will be reported in the final return of the deceased partner. All of it will be included in the return of the partner's estate or other successor in interest.

However, if the partnership terminates with the death of a partner, the partnership year closes for all partners. The deceased partner's share of income for that year will be included in

the deceased partner's final return. If the decedent's tax year is different from the partnership's, the decedent's final return will include his or her share of partnership items for both the partnership year ending with the decedent's death and any partnership year ending earlier in the decedent's last tax year.

**Self-employment income.** A different rule applies in computing a deceased partner's self-employment income. Self-employment income of a partner includes the partner's distributive share of income earned by the partnership through the end of the month in which the partner's death occurs. This is true even though the deceased partner's estate or heirs may succeed to the decedent's rights in the partnership. For this purpose, partnership income for the year in which a partner dies is considered to be earned equally in each month.

**Example.** Larry, a partner in WoodsPar, is a calendar year taxpayer. WoodsPar, the partnership, has a fiscal year ending June 30. For the partnership year ending June 30, 1994, Larry's distributive share of partnership profits is \$2,000. On August 18, 1994, Larry dies. For the partnership year ending June 30, 1995, assume that the distributive share of Larry and his estate is \$3,000.

Larry's self-employment income to be reported on Schedule SE (Form 1040) for 1994 is \$2,500. This consists of his \$2,000 distributive share for the partnership tax year ending June 30, 1994, plus \$500 of the distributive share for the tax year ending June 30, 1995 ( $\frac{7}{12} \times \$3,000$ ).

However, Larry's partnership income to be reported on Form 1040 for 1994 is \$2,000. This is because his final return includes only his share of partnership income for the partnership year that ended within his last tax year.

## Unrealized Receivables and Inventory Items

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or substantially appreciated inventory items results in ordinary income or loss. The amount received is treated as if it were received for the sale or exchange of property that is not a capital asset.

**Unrealized receivables.** Unrealized receivables are any rights to payment not already included in income for:

- 1) Goods delivered or to be delivered to the extent the payment would be treated as received for property other than a capital asset, or
- 2) Services rendered or to be rendered.

These rights must have arisen under contracts or agreements that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include trade accounts receivable of a

cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partnership share.

The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting.

**Items included as unrealized receivables.** When either of the following transactions occur, unrealized receivables include the section 1245 gain that would be treated as ordinary income (depreciation recapture) if the partnership had sold certain depreciable property at its fair market value.

- 1) A distribution by a partnership to a partner, or
- 2) A sale or exchange of an interest in a partnership by a partner.

Unrealized receivables include the amount of potential gain that would be ordinary income from:

- 1) Mining property.
- 2) Stock in an Interest Charge Domestic International Sales Corporation (IC-DISC).
- 3) Certain farmland for which expenses for soil and water conservation or land clearing were deducted.
- 4) Franchises, trademarks, or trade names.
- 5) Oil, gas, or geothermal property.
- 6) Stock of certain controlled foreign corporations.
- 7) Market discount bonds and short-term obligations.
- 8) Recapture of deductions under IRC sections 1245 (discussed earlier), 1250, 1253, etc.

**Determining value.** Generally, any arm's-length agreement between the buyer and the seller (or between the partnership and the partner receiving the distribution) will establish the amount or value of:

- 1) The sales price of unrealized receivables, or
- 2) The value of the receivables received in a distribution that is treated as a sale or exchange.

If no agreement exists, an allowance must be made for the estimated cost to complete performance of the contract or agreement, and for the time between the sale or distribution and the time of payment.

**Example.** You are a partner in ABC Partnership. The adjusted basis of your partnership interest at the end of the current year is zero. Your share of potential ordinary income from partnership depreciable property is \$5,000. The partnership has no other unrealized receivables or substantially appreciated inventory items. You sell your interest in the partnership for \$10,000 in cash.

The amount you realize from the sale of your partnership interest is \$10,000. Since the

adjusted basis of your interest in the partnership is zero, you report the entire \$10,000 as a gain. You report the \$5,000 as ordinary income. This amount represents your share of potential ordinary income from partnership depreciable property. You report the remaining \$5,000 gain as capital gain.

**Inventory items that have appreciated substantially in value.** Before May 1, 1993, inventory items of the partnership were considered to have appreciated substantially in value if, at the time of the sale or distribution, their total fair market value is more than:

- 1) 120% of the partnership's adjusted basis for the property, and
- 2) 10% of the fair market value of all partnership property other than money.

However, if a principal purpose for acquiring inventory property was to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

**Modified definition.** For sales, exchanges, and distributions made after April 30, 1993, the definition of substantially appreciated inventory has been modified to eliminate the requirement that the partnership's inventory exceed 10% of the value of all partnership property, other than money, in order to be substantially appreciated. If the partnership's inventory is worth more than 120% of its adjusted basis, the inventory is treated as substantially appreciated.

**Items included as inventory.** Inventory items are not just stock-in-trade of the partnership. They include any property that is part of inventory on hand at the end of the tax year or that is held primarily for sale to customers in the normal course of business. They include any asset which, if sold or exchanged by the partnership, would not be a capital asset or treated as a capital asset. They also include any other property held by the partnership that would be considered inventory if held by the selling or distributee partner. Inventory also includes trade or accounts receivable acquired for services or from the sale of inventory.

**Example.** Assume that you sell your 1/3 interest in your partnership. The partnership uses an accrual method of accounting, has no liabilities, and has the following assets:

Assets	Adjusted Basis	Fair Market Value
Cash	\$ 10,000	\$ 10,000
Accounts receivable	5,000	2,500
Trade notes receivable	2,000	2,100
Merchandise on hand	4,000	9,500
Land	80,000	100,000
<b>Total assets</b>	<b>\$101,000</b>	<b>\$124,100</b>

The inventory items—the accounts receivable, trade notes receivable, and merchandise—have a total adjusted basis of \$11,000 and a fair market value of \$14,100. The total value of all assets other than cash is \$114,100. Because the fair market value of the inventory

items (\$14,100) is more than 120% of their adjusted basis (\$11,000), the partnership has substantially appreciated inventory items. You will realize ordinary income to the extent the amount you receive for your interest in the inventory items exceeds your basis in them. If the amount you receive for your interest in the other assets exceeds the basis of your interest in them, you will realize a gain to the extent the amount received exceeds the basis of your interest in the assets.

**Notifying partnership.** If a partner exchanges a partnership interest attributable to unrealized receivables or substantially appreciated inventory items for money or property, he or she must notify the partnership in writing. This must be done within 30 days of the transaction or, if earlier, by January 15 of the calendar year following the calendar year of the exchange.

**Information returns required of partnership.** When a partnership is notified of an exchange of partnership interests involving unrealized receivables or substantially appreciated inventory items, the partnership must file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*. Form 8308 is filed with Form 1065 for the tax year that includes the last day of the calendar year in which the exchange took place. If notified of an exchange after filing Form 1065, the partnership must file Form 8308 separately, within 30 days of the notification.

On Form 8308, the partnership states the date of the exchange, and the names, addresses, and taxpayer identification numbers of the transferee and transferor in the exchange and of the partnership filing the return. The partnership must also provide a copy of Form 8308 (or a written statement with the same information) to each transferee and transferor by the later of January 31 following the end of the calendar year or 30 days after it receives notice of the exchange.

**Penalties.** There is a penalty of up to \$50 for each failure to timely file or include complete and correct information on a required information return, up to a maximum of \$250,000 for any calendar year. The penalty may be reduced if the failure is corrected within specified time periods. If the average annual gross receipts of the partnership for the 3 tax years prior to the current year are \$5 million or less, the maximum amount of the penalty is \$100,000. If the failure to file or include complete and correct information is intentional, the penalty can be more.

There is a penalty of \$50 for each failure to furnish a statement to a transferor or transferee, up to a maximum of \$100,000 for any calendar year.

A partner will be subject to a penalty of \$50 for each failure to notify the partnership of an exchange of a partnership interest attributable to unrealized receivables or substantially appreciated inventory items, up to a maximum of \$100,000 for any calendar year.

These penalties will not apply if it is shown that the failure was due to reasonable cause and not to willful neglect.

For detailed guidance on the information reporting requirements, see Regulations sections 301.6721-1 through 301.6724-1.

**Statement required of partner.** If a partner sells or exchanges any part of an interest in a partnership having unrealized receivables or substantially appreciated inventory items, he or she must file a statement with his or her tax return for the year in which the sale or exchange occurs. The statement must contain the following information.

- 1) The date of the sale or exchange, the amount of the partner's adjusted basis for the partnership interest, and the part of the basis that represents unrealized receivables or substantially appreciated inventory items.
- 2) The amount of money and the fair market value of any other property the partner received or will receive for the interest in the partnership, and the part that represents unrealized receivables or substantially appreciated inventory items.
- 3) The statement described earlier under *Special adjustment to basis of property received* if the partner computes the basis for the unrealized receivables or substantially appreciated inventory items under that provision.
- 4) The computation described earlier under *Optional Adjustment to Basis of Partnership Property*, if the partnership used the optional adjustment, and the partnership properties to which the adjustment has been allocated.

**Sale or exchange of certain distributed property.** In general, any gain or loss on a sale or exchange of unrealized receivables or appreciated inventory a partner receives in a distribution is an ordinary gain or loss. For this purpose, inventory does not include assets held for use in a trade or business, even if they are not held for a period that would qualify them for treatment as capital assets. If a distributee partner disposes of unrealized receivables or inventory items in a nontaxable exchange, the ordinary gain or loss treatment applies to a later disposition of any property he or she receives in the nontaxable exchange.

**Inventory items held more than 5 years.** If a distributee partner sells inventory items that he or she held for more than 5 years, the type of gain or loss depends on how they are being used on the date sold. The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold.

**Example 1.** Ann receives, through dissolution, inventory that has a basis of \$19,000. Within 5 years, she sells the inventory for \$24,000. The \$5,000 gain is taxed to her as ordinary income. If she had held the inventory for more than 5 years, her gain would have been capital gain, provided the inventory was a capital asset in her hands at the time of sale.

**Example 2.** Bill, a distributee partner, received \$17,000 as his share of accounts receivable when his law firm dissolved. The partnership used the cash method, so the

receivables had a basis of zero to Bill. If the receivables are later collected, or if Bill sells them, the amount received will be ordinary income. The 5-year rule, illustrated in Example 1, does not apply to accounts receivable.

## Form 1065 Example

This filled-in Form 1065 is for the AbleBaker Book Store, a partnership composed of Frank Able and Susan Baker. The partnership uses an accrual method of accounting and a calendar year for reporting income and loss. Frank works full time in the business, while Susan works approximately 25% of her time in it. Both partners are general partners.

The partnership agreement states that Frank will receive a yearly guaranteed payment of \$20,000, and Susan will receive \$5,000. Any profit or loss will be shared equally by the partners. The partners are personally liable for all partnership liabilities. Both partners materially participate in the operation of the business.

In addition to income and expenses from partnership business operations, AbleBaker made a \$650 charitable contribution and received \$50 tax-exempt interest from municipal bonds and \$150 from dividends.

Note that each partner's distributive share of specially allocated items should be shown on the appropriate line of the applicable partner's Schedule K-1 and the total amount on Schedule K instead of on page 1, Form 1065. An item is specially allocated if it is allocated to a partner in a ratio different from the ratio for sharing income or loss generally.

## Page 1

When the return is completed, the preaddressed label from the cover of the Form 1065 package mailed to the partnership is placed in the address area of the form. Any necessary corrections should be made on the label. If the partnership does not receive a Form 1065 package with a preaddressed label, the partnership should enter its name and address in this area. The partnership must supply all the information asked for at the top of page 1, Form 1065.

## Income

The partnership's ordinary income (loss) from the trade or business activity is shown on lines 1a through 8.

**Line 1.** Gross sales of \$409,465 are entered on line 1a. Returns and allowances of \$3,365 are entered on line 1b, resulting in net sales of \$406,100, entered on line 1c.

**Line 2.** Cost of goods sold, \$267,641, from Schedule A, line 8, is entered here.

**Line 3.** Gross profit of \$138,459 is shown on this line.

**Line 7.** Interest income on accounts receivable, \$559, is entered on this line. The schedule that must be attached for this line is not shown.

**Line 8.** Total income, \$139,018 (lines 3 through 7), is shown on line 8.

## Deductions

The partnership's allowable deductions are shown next on lines 9 through 21.

**Line 9.** All salaries and wages are included on line 9, except guaranteed payments to partners (shown on line 10). The AbleBaker Book Store lists \$29,350 on line 9. They had no employment credits to reduce that amount.

**Line 10.** Guaranteed payments of \$25,000 to partners Frank (\$20,000) and Susan (\$5,000) are entered here. A guaranteed payment for interest paid to a partner is entered here, not on line 15.

**Line 11.** Repairs of \$1,125 made to partnership equipment are entered on this line. To qualify for the deduction, repairs must not add to the value or appreciably prolong the life of the property repaired.

**Line 12.** During the year, \$250 owed to the partnership was determined to be a wholly worthless business bad debt. If this had been a nonbusiness bad debt, it would be included in the partnership's separately stated short-term capital loss.

The \$250 is shown on line 12. If business bad debts previously written off and deducted are collected in later years, the amount collected generally must be included in partnership gross income for the year the amount is collected. See Chapter 14 in Publication 535 for more information.

**Line 13.** Rent paid for the business premises, \$20,000, is listed on this line.

**Line 14.** Deductible taxes of \$3,295 are entered on this line.

**Line 15.** Interest paid to suppliers during the year totaled \$1,451. This is business interest, so it is entered on line 15. Interest paid to a partner that is not a guaranteed payment is also included on this line. For more information, see Chapter 8 in Publication 535.

**Lines 16a and 16c.** Depreciation of \$1,174 claimed on assets used in a trade or business is entered on these lines. Line 16b is for depreciation claimed elsewhere on the return. Form 4562 is completed only if the partnership placed property in service during 1994 or it claims any depreciation on a car or other listed property. Form 4562 is not shown in this example.

**Line 20.** Other allowable deductions of \$8,003 not claimed elsewhere on the return or for which a separate line is not provided on page 1 are included on this line. The partnership attaches a schedule that lists each deduction and its amount that is included on line 20. This schedule is not illustrated.

**Line 21.** The total of all deductions, \$89,648 (lines 9 through 20), is entered on this line.

**Line 22.** The amount on line 21 is subtracted from the amount on line 8. The result, \$49,370, is entered on line 22 of page 1 and is allocated to each partner on line 1 of Schedule K-1. The total is shown on line 1 of Schedule K.

## Signatures

The return must be signed by a general partner. Also, any person, firm, or corporation that prepares the return for compensation, other than a full-time employee of the partnership, must sign it. The AbleBaker Book Store did not have a paid preparer who was required to sign the return.

## Page 2 Schedule A

Schedule A shows the computation of cost of goods sold. Beginning inventory, \$18,125 (entered on line 1), is added to net purchases, \$268,741, and is entered on line 2. The total, \$286,866, is entered on line 6. Ending inventory, \$19,225 (entered on line 7), is subtracted from the amount on line 6 to arrive at cost of goods sold, \$267,641 (entered on line 8 and on page 1, line 2).

The partnership answered all applicable questions for item 9.

## Schedule B

Schedule B contains 11 questions pertaining to the partnership. Answer question 1 by marking the appropriate box. Answer questions 2 through 11 by marking the "yes" or "no" boxes.

Question 5 asks if the partnership meets all the requirements listed in items 5a, b, and c. If all three of these requirements are met, mark the "yes" box to Question 5 and the partnership is not required to complete Schedules L, M-1, and M-2.

## Page 3 Schedule K

Schedule K must be completed by all partnerships. It lists the total of all partners' shares of income, deductions, credits, etc. The partnership agreement can provide for the manner in which the partners will share each item of income, gain, loss, deduction, or credit, etc., of the partnership. If the main purpose of any provision in the partnership agreement regarding a partner's share of any item is to evade or avoid federal income tax, the provision will be disregarded.

Each partner's distributive share of income, deductions, credits, etc., should be reported on Schedule K-1. The line items for Schedule K are discussed in combination with the Schedule K-1 line items, later.

## Page 4 Schedules L, M-1, and M-2

Partnerships do not have to complete Schedules L, M-1, or M-2 if all of the tests listed under Question 5 are met and Question 5 on page 2 is marked "Yes." The AbleBaker Book Store does not meet all of the tests, so these schedules must be completed.

### Schedule L

Schedule L contains the partnership's balance sheets at the beginning and end of the tax year. All information shown on the balance

sheets for the AbleBaker Book Store should agree with its books of account. Any differences should be reconciled and explained in a separate schedule attached to the return.

The entry for total assets at the end of the year, \$45,391, is carried to Item F at the top of page 1 if Item F is required to be completed. See the instructions for Form 1065 for more information.

### Schedule M-1

Schedule M-1 is the reconciliation of income per the partnership books with income per Form 1065.

**Line 1.** This line shows the net income per books of \$48,920. This amount is from the profit and loss account (not shown in this example).

**Line 3.** This line shows the guaranteed payments to partners.

**Line 5.** This is the total of lines 1 through 4 of \$73,920.

**Line 6.** Included in line 6 is the \$50 tax-exempt interest income from municipal bonds that is recorded on the books but is not included on Schedule K, lines 1 through 7. Each partner's share of this interest is reported on his or her Schedule K-1 on line 19.

**Line 9.** This line is the same as Schedule K, line 23a. It is also the same as line 5 less line 8 (Schedule M-1), \$73,870.

### Schedule M-2

Schedule M-2 is an analysis of the partners' capital accounts. It shows the total equity of all partners at the beginning and end of the tax year and the adjustments that caused any increase or decrease. The total of all the partners' capital accounts is the difference between the partnership's assets and liabilities shown on Schedule L. A partner's capital account will not necessarily represent the tax basis for an interest in the partnership.

**Line 1.** As of January 1, the total of the partners' capital accounts was \$27,550 (Frank — \$14,050; Susan — \$13,500). This amount should agree with the beginning balance shown on Schedule L for the partners' capital accounts.

**Line 3.** This is the net income per books.

**Line 5.** This is the total of lines 1 through 4.

**Line 6.** Each partner withdrew \$26,440 (totaling \$52,880) from the partnership. The partners' guaranteed payments, which were actually paid, are not included in this column because they were deducted in arriving at the amount shown on line 3. Any other distributions to the partners, in cash or property other than cash, would also be included here.

**Line 9.** This shows the total equity of all partners as shown in the books of account as of December 31. This amount should agree with the year-end balance shown on Schedule L for the partners' capital accounts.

Item J on Schedule K-1 reflects each partner's share of the amounts shown on lines 1 through 9 of Schedule M-2.

## Schedule K-1

Schedule K-1 lists each partner's share of income, deductions, credits, etc. It also shows where to report the items on the partner's individual income tax return. Illustrated is a copy of the Schedule K-1 for Frank W. Able. All information asked for at the top of Schedule K-1 must be supplied for each partner.

Since all line items on Schedule K-1 are not applicable to every partnership, a substitute Schedule K-1 may be used. See the instructions for Form 1065 for more information.

## Allocation of Partnership Items

The partners' shares of income, deductions, etc., are shown next in lines 1 through 22, Schedule K, and lines 1 through 23, Schedule K-1.

### Income (Loss)

**Line 1.** This line on Schedule K-1 shows Frank's share (\$24,685) of the income from the partnership shown on Form 1065, page 1, line 22. The total amount of income to both partners is shown on line 1, Schedule K.

**Line 4b.** Dividends must be separately stated. They are not included in the income (loss) of the partnership on Form 1065, page 1, line 22. This line on Schedule K-1 shows Frank's share, \$75. This line on Schedule K shows the total dividends of \$150.

**Line 5.** This line on Schedule K-1 shows only the guaranteed payments to Frank of \$20,000. This line on Schedule K shows the total guaranteed payments to both partners of \$25,000.

### Deductions

**Line 8.** During the year, the partnership made a \$650 contribution to the American Lung Association. Each partner can deduct all or part of his or her share of the partnership's charitable contribution on his or her individual income tax return if the partner itemizes deductions. Frank's share of the contribution, \$325, is entered on line 8, Schedule K-1. This line on Schedule K shows the total contribution. For more information, see Publication 526, *Charitable Contributions*.

### Investment Interest

**Lines 12a-12b.** The partnership's total interest on investment debt and items of investment income and expenses is entered on the applicable lines of Schedule K, and each partner's share is entered on Schedule K-1. For more information, see Publication 550, *Investment Income and Expenses*, and the instructions for Form 1065. This partnership did not have any investment interest expense or other investment expenses. It did have investment income as shown on line 4b, Schedule K. The total of all investment income, lines 4a, 4b, 4c, and 4f, is shown on line 12b(1), Schedule K, and the partner's share is shown on line 12b(1), Schedule K-1.

## Self-Employment Tax

**Line 15a.** Net earnings (loss) from self-employment are entered on Schedule K, and each individual partner's share is shown on his or her Schedule K-1. Guaranteed payments are included in net earnings from self-employment. Each partner uses his or her share to figure his or her self-employment tax on Schedule SE (Form 1040), *Self-Employment Tax*. (Not shown.)

## Tax-Exempt Interest Income

**Line 19.** Tax-exempt interest income, including any exempt-interest dividends received from a mutual fund or other regulated

investment company, is entered here. Frank enters \$25 on line 19.

## Analysis

**Lines 23a–23b (Schedule K only).** An analysis must be made of the distributive items on Schedule K. This analysis is based on the

type of partner. Since the AbleBaker Book Store has two persons, both of whom are general partners, the entries are \$73,870 on lines 23a and 23b(1), column (b)i.

**U.S. Partnership Return of Income**For calendar year 1994, or tax year beginning ....., 1994, and ending ....., 19 .....,  
▶ See separate instructions.

OMB No. 1545-0099

**1994**

A Principal business activity <b>Retail</b>	Use the IRS label. Otherwise, please print or type.	Name of partnership 10-9876543 DEC94 D71 AbleBaker Book Store 334 West Main Street Orange, MD 20904	D Employer identification number
B Principal product or service <b>Books</b>			E Date business started <b>10-1-79</b>
C Business code number <b>5942</b>			F Total assets (see specific instructions) <b>\$ 45,391</b>

- G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return  
H Check accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶ .....  
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ **2**

**Caution:** Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

<b>Income</b>	1a Gross receipts or sales	1a	<b>409,465</b>		
	b Less returns and allowances	1b	<b>3,365</b>		
	2 Cost of goods sold (Schedule A, line 8)	2	<b>267,641</b>		
	3 Gross profit. Subtract line 2 from line 1c	3	<b>138,459</b>		
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach schedule)	4			
	5 Net farm profit (loss) (attach Schedule F (Form 1040))	5			
	6 Net gain (loss) from Form 4787, Part II, line 20	6			
	7 Other income (loss) (see instructions) (attach schedule)	7	<b>559</b>		
8 Total income (loss). Combine lines 3 through 7	8	<b>139,018</b>			
<b>Deductions</b> (see instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)	9	<b>29,350</b>		
	10 Guaranteed payments to partners	10	<b>25,000</b>		
	11 Repairs and maintenance	11	<b>1,125</b>		
	12 Bad debts	12	<b>250</b>		
	13 Rent	13	<b>20,000</b>		
	14 Taxes and licenses	14	<b>3,295</b>		
	15 Interest	15	<b>1,451</b>		
	16a Depreciation (see instructions)	16a	<b>1,174</b>		
	b Less depreciation reported on Schedule A and elsewhere on return	16b	<b>-0-</b>		
	17 Depletion (Do not deduct oil and gas depletion.)	17			
	18 Retirement plans, etc.	18			
	19 Employee benefit programs	19			
	20 Other deductions (attach schedule)	20	<b>8,003</b>		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21	<b>89,648</b>			
22 Ordinary income (loss) from trade or business activities. Subtract line 21 from line 8	22	<b>49,370</b>			

<b>Please Sign Here</b>	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner) is based on all information of which preparer has any knowledge.			
	Signature of general partner or limited liability company member <b>Frank H. Able</b>	Date <b>3-12-95</b>		
<b>Paid Preparer's Use Only</b>	Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's social security no.
	Firm's name (or yours if self-employed) and address	E.I. No.		
			ZIP code	

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Cat. No. 11380Z

Form **1065** (1994)

**Schedule A Cost of Goods Sold**

1	Inventory at beginning of year . . . . .	1	18,125
2	Purchases less cost of items withdrawn for personal use . . . . .	2	268,741
3	Cost of labor . . . . .	3	-0-
4	Additional section 263A costs (see instructions) (attach schedule) . . . . .	4	-0-
5	Other costs (attach schedule) . . . . .	5	-0-
6	<b>Total.</b> Add lines 1 through 5 . . . . .	6	286,866
7	Inventory at end of year . . . . .	7	19,225
8	<b>Cost of goods sold.</b> Subtract line 7 from line 6. Enter here and on page 1, line 2 . . . . .	8	267,641

9a Check all methods used for valuing closing inventory:

- (i) ☐ Cost  
 (ii) ☒ Lower of cost or market as described in Regulations section 1.471-4  
 (iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)  
 (iv) ☐ Other (specify method used and attach explanation) ▶

- b Check this box if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) . . . ▶ ☐  
 c Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? . . . ☐ Yes ☒ No  
 d Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☒ No  
 If "Yes," attach explanation.

**Schedule B Other Information**

	Yes	No
1 What type of entity is filing this return? Check the applicable box ▶ <input checked="" type="checkbox"/> General partnership <input type="checkbox"/> Limited partnership <input type="checkbox"/> Limited liability company		
2 Are any partners in this partnership also partnerships? . . . . .		<input checked="" type="checkbox"/>
3 Is this partnership a partner in another partnership? . . . . .		<input checked="" type="checkbox"/>
4 Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see Designation of Tax Matters Partner below . . . . .		<input checked="" type="checkbox"/>
5 Does this partnership meet ALL THREE of the following requirements? a The partnership's total receipts for the tax year were less than \$250,000; b The partnership's total assets at the end of the tax year were less than \$600,000; AND c Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item J on Schedule K-1 . . . . .		
6 Does this partnership have any foreign partners? . . . . .		<input checked="" type="checkbox"/>
7 Is this partnership a publicly traded partnership as defined in section 469(k)(2)? . . . . .		<input checked="" type="checkbox"/>
8 Has this partnership filed, or is it required to file, Form 8264, Application for Registration of a Tax Shelter? . . . . .		<input checked="" type="checkbox"/>
9 At any time during calendar year 1994, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See the instructions for exceptions and filing requirements for Form TD F 90-22.1.) If "Yes," enter the name of the foreign country. ▶ . . . . .		<input checked="" type="checkbox"/>
10 Was the partnership the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the partnership or any partner has any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926 . . . . .		<input checked="" type="checkbox"/>
11 Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under Elections Made By the Partnership . . . . .		<input checked="" type="checkbox"/>

**Designation of Tax Matters Partner (See instructions.)**

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶

Identifying number of TMP ▶

Address of designated TMP ▶

**Schedule K Partners' Shares of Income, Credits, Deductions, etc.**

		(a) Distributive share items		(b) Total amount			
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 22)		1	49,370		
	2	Net income (loss) from rental real estate activities (attach Form 8825)		2			
	3a	Gross income from other rental activities	3a				
	3b	Expenses from other rental activities (attach schedule)	3b				
	3c	Net income (loss) from other rental activities. Subtract line 3b from line 3a		3c			
	4a	Portfolio income (loss) (see instructions): a Interest income		4a			
	4b	Dividend income	4b	150			
	4c	Royalty income	4c				
	4d	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	4d				
	4e	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	4e				
	4f	Other portfolio income (loss) (attach schedule)	4f				
Deductions	5	Guaranteed payments to partners		5	25,000		
	6	Net gain (loss) under section 1231 (other than due to casualty or theft) (attach Form 4797)		6			
	7	Other income (loss) (attach schedule)		7			
Investment Interest	8	Charitable contributions (see instructions) (attach schedule)		8	650		
	9	Section 179 expense deduction (attach Form 4562)		9			
Credits	10	Deductions related to portfolio income (see instructions) (itemize)		10			
	11	Other deductions (attach schedule)		11			
	12a	Interest expense on investment debts		12a			
	12b(1)	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	12b(1)	150			
	12b(2)	(2) Investment expenses included on line 10 above	12b(2)				
	13a	Credit for income tax withheld		13a			
	13b(1)	(1) Low-income housing credit (see instructions): From partnerships to which section 42(j)(5) applies for property placed in service before 1990	13b(1)				
	13b(2)	(2) Other than on line 13b(1) for property placed in service before 1990	13b(2)				
	13b(3)	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	13b(3)				
	13b(4)	(4) Other than on line 13b(3) for property placed in service after 1989	13b(4)				
	13c	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)		13c			
13d	Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions)		13d				
13e	Credits related to other rental activities (see instructions)		13e				
14	Other credits (see instructions)		14				
Self-Employment	15a	Net earnings (loss) from self-employment		15a	74,370		
	15b	Gross farming or fishing income		15b			
	15c	Gross nonfarm income		15c			
Adjustments and Tax Preference Items	16a	Depreciation adjustment on property placed in service after 1986		16a			
	16b	Adjusted gain or loss		16b			
	16c	Depletion (other than oil and gas)		16c			
	16d(1)	(1) Gross income from oil, gas, and geothermal properties	16d(1)				
	16d(2)	(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)				
	16e	Other adjustments and tax preference items (attach schedule)		16e			
Foreign Taxes	17a	Type of income ▶	b Foreign country or U.S. possession ▶				
	17c	Total gross income from sources outside the United States (attach schedule)		17c			
	17d	Total applicable deductions and losses (attach schedule)		17d			
	17e	Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued		17e			
	17f	Reduction in taxes available for credit (attach schedule)		17f			
	17g	Other foreign tax information (attach schedule)		17g			
	18a	Total expenditures to which a section 59(e) election may apply		18a			
Other	18b	Type of expenditures ▶					
	19	Tax-exempt interest income		19	50		
	20	Other tax-exempt income		20			
	21	Nondeductible expenses		21			
	22	Other items and amounts required to be reported separately to partners (see instructions) (attach schedule)					
Analysis	23a	Income (loss). Combine lines 1 through 7 in column (b). From the result, subtract the sum of lines 8 through 12a, 17e, and 18a		23a	73,870		
	b	Analysis by type of partner:	(a) Corporate	(b) Individual	(c) Partnership	(d) Exempt organization	(e) Nominee/Other
	(1) General partners		73,870				
(2) Limited partners							



**Note:** If Question 5 of Schedule B is answered "Yes," the partnership is not required to complete Schedules L, M-1, and M-2.

### Schedule L Balance Sheets

Assets	Beginning of tax year		End of tax year	
	(a)	(b)	(c)	(d)
1 Cash . . . . .		3,455		3,350
2a Trade notes and accounts receivable . . . . .	7,150		10,990	
b Less allowance for bad debts . . . . .		7,150		10,990
3 Inventories . . . . .		18,125		19,225
4 U.S. government obligations . . . . .				
5 Tax-exempt securities . . . . .		1,000		1,000
6 Other current assets (attach schedule) . . . . .				
7 Mortgage and real estate loans . . . . .		1,000		1,000
8 Other investments (attach schedule) . . . . .				
9a Buildings and other depreciable assets . . . . .	15,000		15,000	
b Less accumulated depreciation . . . . .	4,000	11,000	5,174	9,826
10a Depletable assets . . . . .				
b Less accumulated depletion . . . . .				
11 Land (net of any amortization) . . . . .				
12a Intangible assets (amortizable only) . . . . .				
b Less accumulated amortization . . . . .				
13 Other assets (attach schedule) . . . . .		41,730		45,391
14 Total assets . . . . .				
<b>Liabilities and Capital</b>				
15 Accounts payable . . . . .		10,180		10,462
16 Mortgages, notes, bonds payable in less than 1 year . . . . .		4,000		3,600
17 Other current liabilities (attach schedule) . . . . .				
18 All nonrecourse loans . . . . .				
19 Mortgages, notes, bonds payable in 1 year or more . . . . .				7,739
20 Other liabilities (attach schedule) . . . . .				
21 Partners' capital accounts . . . . .		27,550		23,590
22 Total liabilities and capital . . . . .		41,730		45,391

### Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return (see instructions)

1 Net income (loss) per books . . . . .	48,920	6 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize):	
2 Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize): . . . . .		a Tax-exempt interest \$ 50 . . . . .	50
3 Guaranteed payments (other than health insurance) . . . . .	25,000	7 Deductions included on Schedule K, lines 1 through 12a, 17e, and 18a, not charged against book income this year (itemize):	
4 Expenses recorded on books this year not included on Schedule K, lines 1 through 12a, 17e, and 18a (itemize):		a Depreciation \$ . . . . .	
a Depreciation \$ . . . . .		b Add lines 6 and 7 . . . . .	50
b Travel and entertainment \$ . . . . .		9 Income (loss) (Schedule K, line 23a). Subtract line 8 from line 5 . . . . .	73,870
5 Add lines 1 through 4 . . . . .	73,920		

### Schedule M-2 Analysis of Partners' Capital Accounts

1 Balance at beginning of year . . . . .	27,550	6 Distributions: a Cash . . . . .	52,880
2 Capital contributed during year . . . . .		b Property . . . . .	
3 Net income (loss) per books . . . . .	48,920	7 Other decreases (itemize): . . . . .	
4 Other increases (itemize): . . . . .			
5 Add lines 1 through 4 . . . . .	76,470	8 Add lines 6 and 7 . . . . .	52,880
		9 Balance at end of year. Subtract line 8 from line 5 . . . . .	23,590

**SCHEDULE K-1**  
**(Form 1065)**

Department of the Treasury  
Internal Revenue Service

**Partner's Share of Income, Credits, Deductions, etc.**

▶ See separate instructions.

OMB No. 1545-0099

**1994**

For calendar year 1994 or tax year beginning

, 1994, and ending

, 19

Partner's identifying number ▶ **123-00-6789**

Partnership's identifying number ▶ **10-9876543**

Partner's name, address, and ZIP code

**Frank W. Able**  
**10 Green Street**  
**Orange, MD 20904**

Partnership's name, address, and ZIP code

**Able Baker Book Store**  
**334 West Main Street**  
**Orange, MD 20904**

**A** This partner is a ☒ general partner ☐ limited partner  
☐ limited liability company member

**B** What type of entity is this partner? ▶ **Individual**

**C** Is this partner a ☒ domestic or a ☐ foreign partner?

**D** Enter partner's percentage of: (i) Before change or termination (ii) End of year

Profit sharing . . . . . % **50** %

Loss sharing . . . . . % **50** %

Ownership of capital . . . . . % **50** %

**E** IRS Center where partnership filed return: **Philadelphia**

**F** Partner's share of liabilities (see instructions):

Nonrecourse . . . . . \$

Qualified nonrecourse financing . . . . . \$

Other . . . . . \$ **10,900**

**G** Tax shelter registration number . ▶ **N/A**

**H** Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐

**I** Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

**J Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
<b>14,050</b>		<b>24,460</b>	<b>(26,440)</b>	<b>12,070</b>

(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
<b>Income (Loss)</b>	<b>1</b> Ordinary income (loss) from trade or business activities . . . . .	<b>1</b> <b>24,685</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>2</b> Net income (loss) from rental real estate activities . . . . .	<b>2</b>	
	<b>3</b> Net income (loss) from other rental activities . . . . .	<b>3</b>	
	<b>4</b> Portfolio income (loss):		Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) or (g) Sch. D, line 13, col. (f) or (g) Enter on applicable line of your return
	<b>a</b> Interest . . . . .	<b>4a</b>	
	<b>b</b> Dividends . . . . .	<b>4b</b> <b>75</b>	
	<b>c</b> Royalties . . . . .	<b>4c</b>	
	<b>d</b> Net short-term capital gain (loss) . . . . .	<b>4d</b>	
	<b>e</b> Net long-term capital gain (loss) . . . . .	<b>4e</b>	
	<b>f</b> Other portfolio income (loss) (attach schedule) . . . . .	<b>4f</b>	
	<b>5</b> Guaranteed payments to partner . . . . .	<b>5</b> <b>20,000</b>	See Partner's Instructions for Schedule K-1 (Form 1065). Enter on applicable line of your return
	<b>6</b> Net gain (loss) under section 1231 (other than due to casualty or theft) . . . . .	<b>6</b>	
	<b>7</b> Other income (loss) (attach schedule) . . . . .	<b>7</b>	
<b>Deductions</b>	<b>8</b> Charitable contributions (see instructions) (attach schedule) . . . . .	<b>8</b> <b>325</b>	Sch. A, line 15 or 16
	<b>9</b> Section 179 expense deduction . . . . .	<b>9</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>10</b> Deductions related to portfolio income (attach schedule) . . . . .	<b>10</b>	
	<b>11</b> Other deductions (attach schedule) . . . . .	<b>11</b>	
<b>Investment Interest</b>	<b>12a</b> Interest expense on investment debts . . . . .	<b>12a</b>	Form 4952, line 1
	<b>b</b> (1) Investment income included on lines 4a, 4b, 4c, and 4f above	<b>b(1)</b> <b>75</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	(2) Investment expenses included on line 10 above . . . . .	<b>b(2)</b>	
<b>Credits</b>	<b>13a</b> Credit for income tax withheld . . . . .	<b>13a</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>b</b> Low-income housing credit:		
	(1) From section 42(j)(5) partnerships for property placed in service before 1990 . . . . .	<b>b(1)</b>	Form 8586, line 5
	(2) Other than on line 13b(1) for property placed in service before 1990 . . . . .	<b>b(2)</b>	
	(3) From section 42(j)(5) partnerships for property placed in service after 1989 . . . . .	<b>b(3)</b>	
	(4) Other than on line 13b(3) for property placed in service after 1989 . . . . .	<b>b(4)</b>	
	<b>c</b> Qualified rehabilitation expenditures related to rental real estate activities (see instructions) . . . . .	<b>13c</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>d</b> Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions) . . . . .	<b>13d</b>	
	<b>e</b> Credits related to other rental activities (see instructions) . . . . .	<b>13e</b>	
	<b>14</b> Other credits (see instructions) . . . . .	<b>14</b>	

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Cat. No. 11394R

Schedule K-1 (Form 1065) 1994

(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
<b>Self-employment</b>	<b>15a</b> Net earnings (loss) from self-employment . . . . .	<b>15a</b> 44,685	Sch. SE, Section A or B See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>b</b> Gross farming or fishing income . . . . .	<b>15b</b>	
	<b>c</b> Gross nonfarm income . . . . .	<b>15c</b>	
<b>Adjustments and Tax Preference Items</b>	<b>16a</b> Depreciation adjustment on property placed in service after 1986 . . . . .	<b>16a</b>	See Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 8251.
	<b>b</b> Adjusted gain or loss . . . . .	<b>16b</b>	
	<b>c</b> Depletion (other than oil and gas) . . . . .	<b>16c</b>	
	<b>d (1)</b> Gross income from oil, gas, and geothermal properties . . . . .	<b>d(1)</b>	
	<b>(2)</b> Deductions allocable to oil, gas, and geothermal properties . . . . .	<b>d(2)</b>	
	<b>e</b> Other adjustments and tax preference items (attach schedule) . . . . .	<b>16e</b>	
<b>Foreign Taxes</b>	<b>17a</b> Type of income ▶ . . . . .	<b>17a</b>	Form 1116, check boxes
	<b>b</b> Name of foreign country or U.S. possession ▶ . . . . .	<b>17b</b>	Form 1116, Part I
	<b>c</b> Total gross income from sources outside the United States (attach schedule) . . . . .	<b>17c</b>	
	<b>d</b> Total applicable deductions and losses (attach schedule) . . . . .	<b>17d</b>	
	<b>e</b> Total foreign taxes (check one): ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued . . . . .	<b>17e</b>	Form 1116, Part II
	<b>f</b> Reduction in taxes available for credit (attach schedule) . . . . .	<b>17f</b>	Form 1116, Part III
	<b>g</b> Other foreign tax information (attach schedule) . . . . .	<b>17g</b>	See Instructions for Form 1116.
<b>Other</b>	<b>18a</b> Total expenditures to which a section 59(e) election may apply . . . . .	<b>18a</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>b</b> Type of expenditures ▶ . . . . .	<b>18b</b>	
	<b>19</b> Tax-exempt interest income . . . . .	<b>19</b> 25	Form 1040, line 8b
	<b>20</b> Other tax-exempt income . . . . .	<b>20</b>	See Partner's Instructions for Schedule K-1 (Form 1065).
	<b>21</b> Nondeductible expenses . . . . .	<b>21</b>	
	<b>22</b> Recapture of low-income housing credit:		Form 8611, line 8
<b>a</b> From section 42(j)(5) partnerships . . . . .	<b>22a</b>		
<b>b</b> Other than on line 22a . . . . .	<b>22b</b>		
<b>Supplemental Information</b>	<b>23</b> Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed):		



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